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Featuring Charles A. Redd

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Estate Planning in 2018

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I. Tax Reform Provides Significant Changes for Estate Planners

An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, Enacted December 22, 2017 ("2017 Tax Act")

A. Effective Date and Sunset

Most provisions in the 2017 Tax Act became effective January 1, 2018. Except with respect to the change in the calculation of inflation adjustments, many of the changes to business taxes and other changes, discussed below, many of the provisions of the 2017 Tax Act will sunset on January 1, 2026 and the law in effect on December 31, 2017 will become effective again, unless legislation is enacted altering this sunset.

B. New Basic Exclusion Amounts for Estate and Gift Taxes and New Generation-Skipping Transfer Exemption

For estate and gift tax purposes, the 2017 Tax Act increased the basic exclusion amount under IRC § 2010(c)(3) to $10 million as adjusted for inflation with a 2010 base year (the same base year under prior law). Thus, the basic exclusion amount for 2018 for gift and estate tax purposes, and the generation-skipping transfer ("GST") exemption amount under IRC § 2631(c), is $11.18 million. Rev. Proc. 2018-18, 2018-10 I.R.B. 392 (March 5, 2018).

Under the current applicable exclusion amount, the number of decedent's estates subject to federal estate tax may only reach a few thousand, and taxpayers have the ability to make larger gifts during their lives free of gift tax. Fox, Henry & Kaufman, "Confronting the Challenges of Tax Reform: What Happened to the Certainty of Death and Taxes?" ALI-CLE and ACTEC (January 11, 2018).

IRC § 2001(g)(2), enacted as part of the 2017 Tax Act, states that regulations shall be issued to prevent "clawback," *i.e.*, ensuring that, if a decedent used the increased basic exclusion amount for gifts made while the 2017 Tax Act was in effect, and died after the sunset of the 2017 Tax Act, such decedent will not be treated as making prior taxable gifts on such decedent's estate tax return because the increased basic exclusion amount for estate tax purposes was eliminated.

The transfer tax rates were not changed by the 2017 Tax Act.

C. Inflation Adjustments

All provisions in the Code that provide amounts subject to indexing for inflation will utilize the chained consumer price index for all urban consumers ("C-CPI-U" or "Chained Consumer Price Index"). IRC § 1(f)(6); 2017 Tax Act § 11002. This inflation adjustment method is a permanent change to the Code. The use of the Chained Consumer Price Index will result in slower growth of inflation and a slower increase in basic exclusion amount than the prior method, the Consumer Price Index for all Urban Consumers, or CPI-U. Fox, *supra*. It will also cause more taxpayers to be in higher tax brackets over time. Akers, "Selected Highlights of 2017 Tax Act and Estate Planning Considerations," http://www.bessemertrust.com/portal/site/Advisor (January 12, 2018).

D. Income Taxation of Individuals, Trusts and Estates

1. **New Tax Rates.** The 2017 Tax Act modified the tax brackets for married individuals filing a joint return and surviving spouses, heads of household, single individuals and married individuals filing separate returns. IRC § 1. The brackets for married individuals filing a joint return and surviving spouses and single filers are provided below:

Married Individuals Filing a Joint Return and Surviving Spouses

If taxable income is:	The tax is:
Not over $19,050	10% of taxable income
Over $19,050 but not over $77,400	$1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $165,000	$8,907 plus 22% of the excess over $77,400
Over $165,000 but not over $315,000	$28,179 plus 24% of the excess over $165,000
Over $315,000 but not over $400,000	$64,179 plus 32% of the excess over $315,000
Over $400,000 but not over $600,000	$91,379 plus 35% of the excess over $400,000
Over $600,000	$161,379 plus 37% of the excess over $600,000

Single Individuals

If taxable income is:	The tax is:
Not over $9,525	10% of taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700

Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$45,689.50 plus 35% of the excess over $200,000
Over $500,000	$150,689.50 plus 37% of the excess over $500,000

Rev. Proc. 2018-18, 2018-10 I.R.B. 392 (March 5, 2018).

The tax brackets for trusts and estates under the 2017 Tax Act are as follows:

If taxable income is:	The tax is:
Not over $2,550	10% of taxable income
Over $2,550 but not over $9,150	$255 plus 24% of the excess over $2,550
Over $9,150 but not over $12,500	$1,839 plus 35% of the excess over $9,150
Over $12,500	$3,011.50 plus 37% of the excess over $12,500

Rev. Proc. 2018-18, 2018-10 I.R.B. 392 (March 5, 2018).

The tax brackets for capital gains (IRC § 1(j)(5)) and dividends (IRC §§ 1(h)(11), 301) are the same as under prior law except for very slight modifications to the bracket ceilings. The net investment income tax under IRC § 1411 remains intact.

The thresholds for each income tax bracket will be indexed for inflation using C-CPI-U in tax years beginning after December 31, 2018.

2. **Standard Deduction.** The 2017 Tax Act increased the standard deduction to $24,000 for taxpayers filing jointly or for a surviving spouse, $18,000 for head of household and $12,000 for single filers. Taxpayers who are blind or 65 years of age or older are eligible for an increased standard deduction as under prior law. IRC § 63(c)(2), (f). For 2018, the additional amount is $1,300, except that the additional amount is $1,600 for individuals who are also unmarried and not a surviving spouse. Rev. Proc. 2018-18, 2018-10 I.R.B. 392 (March 5, 2018). The amount of the standard deduction will be indexed for inflation using the C-CPI-U in tax years beginning after 2018.

3. **Personal Exemption.** The personal exemption has been suspended. IRC § 151(d); 2017 Tax Act § 11041. The suspension of the personal exemption does not affect the exemption for trusts and estates, except that a qualified disability trust, which under prior law

was entitled to the personal exemption of an individual. The 2017 Tax Act allows a deduction for a qualified disability trust of $4,150 during the years that the personal exemption is suspended. This deduction for qualified disability trusts is indexed for inflation. IRC § 642(b)(2)(C)(iii).

4. <u>Miscellaneous Itemized Deductions</u>. Miscellaneous itemized deductions subject to the 2% floor under IRC § 67(a)-(b) are suspended. IRC § 67(g).

Because many states base their income tax calculation on federal taxable income, the elimination of many itemized deductions due to IRC § 67(g) will increase state income taxes for many individuals, trusts and estates as well. Akers, *supra*.

Note that this does not include expenses of an estate or trust not subject to the 2% floor under IRC § 67(e). Expenses of an estate or trust are not subject to the 2% floor if such expenses would not have been incurred if the property were not held in a trust or estate. Thus, executor and trustee fees and attorney's fees related to trust and estate administration should continue to be deductible. Fox, *supra*. The IRS plans to issue regulations to this effect. Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018).

IRC § 642(h)(2) states that on termination of an estate or trust any deductions (other than the estate or trust exemption and other than the charitable deduction) for the estate or trust in excess of gross income are allowable as deductions to the beneficiaries. This deduction is eliminated due the suspension of miscellaneous itemized deductions for individuals under IRC § 67(g). However, the IRS has announced that it is considering whether this deduction should continue to be a miscellaneous itemized deduction. Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018). Beneficiaries may still claim a trust or estate's net operating losses or capital loss carryovers upon trust or estate termination under IRC § 642(h)(1). Akers, *supra*.

The income tax deduction for estate tax attributable to income in respect of a decedent under IRC § 691(c) was not altered by the 2017 Tax Act. Akers, *supra*.

5. <u>Pease Limitation</u>. The limitation on otherwise allowable itemized deductions that applied to certain high-income taxpayers, often referred to as the "Pease" limitation, has been suspended. IRC § 68; 2017 Tax Act § 11046. Because the 2017 Tax Act suspended many itemized deductions, this suspension of the Pease limitation may be meaningful only to taxpayers who have substantial charitable or home mortgage interest deductions. Akers, *supra*.

6. <u>State and Local Taxes</u>. The deduction for state, local and foreign real property taxes; state and local personal property taxes; and state, local and foreign income taxes (referred to as "SALT" deductions) is now limited to $10,000 per taxable year ($5,000 for a married taxpayer filing a separate return). These cap amounts are not indexed for inflation.

Deductions for state and local real property taxes; state and local personal property taxes; and foreign income taxes incurred in connection with trade or business or from an activity described in IRC § 212 (*i.e.*, investment activities) are not subject to this cap. The deduction for foreign real property taxes is suspended. IRC § 164(b)(6).

7. <u>Alimony and Separate Maintenance; Trusts for Divorced Spouse</u>. The 2017 Tax Act eliminated the above-the-line deduction for alimony and separate maintenance payments under IRC § 215. In addition, the 2017 Tax Act eliminated IRC §§ 61(a)(8) and 71, which required payees of alimony and separate maintenance to include such payments in gross income.

The 2017 Tax Act repealed IRC § 682, which provided that if one spouse created a grantor trust for the benefit of the other spouse and the spouses divorced, thereafter the trust income would not be taxed to the grantor spouse to the extent of any income that the donee-spouse is entitled to receive.

These changes are effective for divorce decrees and separation agreements entered into after 2018. Thus, taxpayers seeking a divorce during 2018 may wish to ensure that the divorce is finalized before the end of the calendar year. Akers, *supra*. Modifications entered into after 2018 are subject to the 2017 Tax Act if the modification expressly states that this provision of 2017 Tax Act applies. 2017 Tax Act § 11051(c)(2). No sunset applies to the repeal of the above provisions regarding alimony and separate maintenance payments and IRC § 682.

The IRS intends to issue regulations regarding the application of IRC § 682 before its repeal is effective. Notice 2018-37, 2018-18 I.R.B. 521 (April 30, 2018). In the Notice, the IRS requested comments on whether guidance is needed regarding the application of IRC §§ 672(e)(1)(A), 674(d), and 677 following a divorce or separation in light of the repeal of IRC § 682.

IRC § 672(e)(1)(A) provides that the grantor of a trust shall be treated as holding any power or interest in such trust held by any individual who was the spouse of the grantor at the time of the creation of such power or interest. IRC § 674(a) provides, in general, that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the trust assets is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. However, IRC § 674(d) provides that IRC § 674(a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a Trustee or Trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, if such power is limited by a reasonably definite external standard that is set forth in the trust instrument. IRC § 677(a) provides that the grantor of a trust shall be treated as the owner of any portion of a trust, whether or not the grantor is treated as such owner under IRC § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, or held or accumulated for future distribution to the grantor or the grantor's spouse. In light of the repeal of IRC § 682, IRC §§ 672(e)(1)(A), 674(a) and 677(a) may have the effect of triggering grantor trust status due to the non-grantor spouse's powers over a trust even after the spouses divorce.

8. <u>Charitable Contributions</u>. The 2017 Tax Act enhanced the deduction for charitable contributions of cash to public charities, private operating foundations, supporting organizations and other entities described in IRC § 170(b)(1)(A) by raising the limit that can be contributed in any one year to 60% of a taxpayer's contribution base (generally, adjusted gross income) from 50%. IRC § 170(b)(1)(G)(i).

The 2017 Tax Act permanently removed the deduction relating to purchases of tickets to college sporting events. Contributions that are linked to the right to purchase such tickets will no longer be considered charitable donations. IRC § 170(l).

The 2017 Tax Act also eliminated the alterative rule for substantiating gifts to donee organizations. Previously, donors who made donations of $250 or more to donee organizations did not need a contemporaneous written acknowledgment from the donee organization if the donee organization filed a return with the required information. This change is effective for taxable years beginning after 2016. IRC § 170(f)(8).

9. <u>Unearned Income of Children (the "Kiddie Tax")</u>. The unearned income of children under 18 years of age (up to 23 years of age in certain circumstances) is now subject to the same ordinary income and capital gain tax brackets that are applied to trust and estate income. IRC § 1(j)(4).

10. <u>Life Settlements of Life Insurance Policies</u>. For purposes of life settlements of life insurance policies, the 2017 Tax Act provides that a taxpayer's basis in a life insurance policy is not reduced by the cost of insurance. This provision reverses the IRS's position, stated in Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, that a taxpayer's basis does include such charges.

New reporting requirements are imposed for life settlements. IRC § 6050Y. The IRS has announced that it will issue guidance on these reporting requirements. Notice 2018-41, 2018-20 I.R.B. 584. Also, the transfer for value rules are excluded from life settlements. IRC § 101(a)(2). These provisions do not sunset after 2025.

11. <u>Retirement Assets</u>. Prior law allowed individuals who converted a traditional IRA to a Roth IRA to reverse the conversion, move the assets back to the traditional IRA (the "recharacterized traditional IRA") and avoid the income tax from a conversion if the conversion was reversed before the extended due date of the taxpayer's individual income tax return for the year of the conversion. While continuing to allow the conversion to a Roth IRA, the 2017 Tax Act removed the ability to recharacterize the conversion. This provision does not sunset after 2025. IRC § 408A(d)(6)(B)(iii).

12. <u>ABLE Accounts</u>. An ABLE account is a tax-favored savings program to meet the qualified disability expenses of the beneficiary of the account. Once the overall limitation on contributions is reached for a calendar year ($15,000 for 2018), the 2017 Tax Act provides that the designated beneficiary of the ABLE account may contribute an additional amount to the ABLE account. The designated beneficiary's contribution cannot exceed the lesser of the federal poverty line for one-person household or the designated beneficiary's compensation for the year. Contributions to an ABLE account may be claimed as a saver's credit on the designated beneficiary's income tax return. The designated beneficiary, or the designated beneficiary's representative, must maintain adequate records of any additional contribution by the designated beneficiary. IRC §§ 529A, 25B. The IRS recently issued Notice

2018-62, 2018-34 I.R.B. 316 (August 20, 2018), stating that it intends to issue proposed regulations to clarify recent law changes to the limits on contributions to ABLE accounts provided in IRC § 529A(b)(2).

13. **529 Plans.** The 2017 Tax Act permits owners of IRC § 529 accounts to rollover funds from such accounts to ABLE accounts, but only if the designated beneficiary (or member of the beneficiary's family) of the IRC § 529 account owns the ABLE account. The amount rolled over is counted against the contribution limit that applies to the ABLE account for the year of the rollover. IRC § 529(c)(3)(C)(i)(III).

In addition, the 2017 Tax Act expanded the definition of "qualified higher education expense" to include up to $10,000 of the cost of enrollment or attendance at an elementary or secondary public, private, or religious school. This expansion of qualified higher education expense does not sunset. IRC § 529(c)(7), (e)(3)(A). The IRS intends to issue regulations regarding these changes. Notice 2018-58, 2018-33 I.R.B. 305 (August 13, 2018).

E. Alternative Minimum Tax

The corporate alternative minimum tax ("AMT") has been repealed. IRC § 55(a). The 2017 Tax Act increased the exemption amounts applicable to individuals for AMT purposes. The AMT exemption amounts for unmarried individuals was increased from $54,300 to $70,300. The AMT exemption amounts for married individuals filing joint returns was increased to $109,400. IRC § 55(d). The exemption for estates and trusts is $24,600. IRC § 55(d)(1); Rev. Proc. 2018-18, 2018-10 I.R.B. 392 (March 5, 2018).

The 2017 Tax Act increased the amount by which the AMT begins to phase out. For married individuals filing joint returns, the phase out begins at $1,000,000 as opposed to $160,900 under prior law. For unmarried individuals, the phase out begins at $500,000 as opposed to $120,700 under prior law. IRC § 55(d); Rev. Proc. 2018-18, 2018-10 I.R.B. 392 (March 5, 2018). For estates and trusts, the phase-out begins at $81,900. Rev. Proc. 2018-22, 2018-18 I.R.B. 524 (April 20, 2018).

F. Tax Exempt Organizations

The 2017 Tax Act imposes an excise tax on highly compensated employees of tax-exempt organizations. The excise tax is imposed at a rate of 21% of compensation in excess of $1 million paid to any of the organization's five highest-paid employees. The excise tax is paid by the organization and not the covered employee(s). The excise tax would also apply to certain parachute payments. IRC § 4960.

The 2017 Tax Act also made changes to the unrelated business income tax ("UBIT"). Under prior law, tax-exempt entities could allocate gains and losses from one trade or business activity against the gains and losses from another trade or business activity for purposes of calculating UBIT. Under the new law, this is no longer possible as unrelated business income must be calculated separately for each activity. The result is that the losses generated by unrelated business income activities computed on a separate basis may not be used to offset the gains of other unrelated business income activities. This rule does not apply to net operating losses that arise in a year before 2018. IRC § 512(a)(6).

G. Taxation of Businesses and Business Interests

1. <u>Corporations</u>. Corporations (subject to tax under Subchapter C of the Code) now pay a flat 21% income tax rate. IRC § 11(b). This rate change is permanent.

The 80% dividend-received deduction has been reduced to 65%. The 70% dividends-received deduction was reduced to 50%. IRC §§ 243, 245, 246, 246A.

2. <u>Net Operating Losses</u>. Net operating loss carryovers are now limited to 80% of taxable income, but such losses be carried forward indefinitely. For most businesses, the loss carryback has been eliminated. IRC § 172.

3. <u>Nonresident Aliens and ESBTs</u>. The 2017 Tax Act allows a nonresident alien individual to be a potential current beneficiary of an electing small business trust. IRC § 1361(c)(2)(B)(v).

4. Deduction for Qualified Business Income.

a. *<u>Introduction</u>*. The 2017 Tax Act enacted new IRC § 199A, which, in general, creates a deduction for the combined qualified business income received from certain pass-through and disregarded entities. The deduction seeks to provide a tax benefit for taxpayers holding an interest in these entities similar to the tax benefit for C corporations arising from the reduction in the corporate tax rate under the 2017 Tax Act. *See* Raatz, "New Section 199A: Simplify Pass-Through Deduction Intricacy," 45 EST. PLAN. 16 (April 2018). This Section does not apply to taxable years beginning after 2025. IRC § 199A(i).

On August 8, 2018, the IRS issued proposed regulations under IRC § 199A. REG-107892-18, 83 Fed. Reg. 40884 (August 16, 2018) (the "Proposed Regulations"). The deadline for comments on the proposed regulations is October 1, 2018.

For individuals, the deduction is available whether the individual claims the standard deduction or itemizes deductions. IRC § 63(b); Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong. 1st Sess, p. 39 (2017). The deduction does not affect the calculation of adjusted gross income. IRC § 62(a); Akers, *supra.*

The deduction is available for individuals, partnerships, S corporations, estates, trusts and any other taxpayer other than a C corporation. IRC § 199A(a). The deduction is applied at the pass-through owner level. IRC § 199A(f)(1); Prop. Reg. § 1.199A-1(e)(1); -6. The deduction is available for up to 20% of the taxpayer's taxable income (without consideration of IRC § 199A) minus the taxpayer's net capital gains (IRC § 1(h)). The deduction cannot exceed the combined qualified business income of the taxpayer. IRC § 199A(a), (e)(1).

The deduction is for income tax purposes only. It is not available to reduce self-employment tax under IRC § 1402 or net investment income tax under IRC § 1411. IRC § 199A(f)(3); Prop. Reg. § 1.199A-1(e)(2); Raatz, *supra*.

b. *<u>Qualified Business Income</u>*. In general, qualified business income ("QBI") means the "deductible amount," determined under IRC § 199A(b)(2), for each qualified trade or business carried on by the taxpayer, plus 20% of qualified REIT dividends and qualified publicly traded partnership income. IRC § 199A(b)(1), (c); Prop. Reg. § 1.199A-1(c)(1).

The deductible amount is the lesser of: (i) 20% of the taxpayer's QBI with respect to the qualified trade or business (defined below) or (ii) the greater of 50% of the W-2 wages with respect to the qualified trade or business, or the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property ("UBIA") ((ii) is hereafter referred to as the "Wage/UBIA Test"). IRC § 199A(b)(2). The Wage/UBIA Test is applied only if taxable income exceeds the threshold amount, discussed below. IRC § 199A(b)(3)(A); Prop. Reg. § 1.199A-1(d)(2)(iv).

Generally, QBI consists of net income from an active trade or business within the United States, less qualified REIT dividends or qualified publicly traded partnership income. It does not include, among other items, capital gains, dividends, non-business interest, wage income received as an employee, any guaranteed payment described in IRC § 707(c) or payments to a partner for acting in a capacity other than a partner under IRC § 707(a). IRC § 199A(c); Prop. Reg. § 1.199A-3(b).

If the calculation of QBI results in a loss for any tax year, such loss is carried over to the next tax year. This has the effect of reducing QBI for the subsequent year. IRC § 199A(c)(2), (d)(2); Prop. Reg. § 1.199A-1(c)(2); Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong. 1st Sess, p. 37 (2017); Raatz, *supra*. If the taxpayer has interests in multiple trades or businesses, however, the Proposed Regulations provide that, for purposes of the W-2 Wage/UBIA Test, the taxpayer would offset the loss against any net income from the other trades or businesses. Prop. Reg. § 1.199A-1(d).

c. ***Qualified Trade or Business; Specified Service Trade or Business; Trade or Business of Being an Employee***. A qualified trade or business is a trade or business other than (i) a specified service trade or business ("SSTB"), or (ii) the trade or business of being an employee. IRC § 199A(d)(1).

In general, a "trade or business" is defined in accordance with the provisions of IRC § 162(a). In addition, the Proposed Regulations provide that the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing and the other trade or business are under common control. Prop. Reg. § 1.199A-1(b)(13).

The exclusion for a SSTB only applies if the taxpayer's taxable income is above the threshold amount, discussed below. These trades or businesses are those in the fields of law, health, accounting, financial services, actuarial science, performing arts, consulting, athletics, brokerage services, investment management or any business where the principal asset is the reputation or skill of one or more of its employees. Notwithstanding this provision, trades or businesses in the fields of engineering and architecture are considered qualified trades or businesses. The Proposed Regulations state that the determination of whether a trade or business is a SSTB would be determined by all relevant factors and not just by state licensing laws. Prop. Reg. § 1.199A-5(b).

If the trade or business is a SSTB and taxable income exceeds the phase-in range above the threshold amount, discussed below, none of the QBI, wages or UBIA for purposes of the Wage/UBIA Test will be taken into account in determining the taxpayer's QBI, even if the item is derived from an activity that is not itself a SSTB. IRC § 199A(d)(2); Prop. Reg. § 1.199A-5(a).

The Proposed Regulations provide that a trade or business would not be considered a SSTB if it has gross receipts of $25 million or less per taxable year and less than 10% of such gross receipts is attributable to the performance of services in a SSTB. If gross receipts are greater than $25 million in a taxable year, the trade or business still would not be a SSTB if less than 5% of the gross receipts are attributable to the performance of services of a SSTB. Prop. Reg. § 1.199A-5(c)(1).

The Proposed Regulations contain anti-abuse rules related to SSTBs. A trade or business that provides 80% or more of its property or services to a SSTB also would be considered a SSTB if there is 50% or more common ownership with the SSTB receiving such property or services. If the trade or business provides less than 80% of its property or services to a SSTB, but has 50% common ownership with the SSTB, the portion of the property or services provided to the commonly-owned SSTB would be considered a SSTB (*i.e.*, the income would be treated as income from a SSTB). These rules would help prevent the division of a SSTB into a SSTB and a non-SSTB for the purpose of increasing the IRC § 199A deduction. Prop. Reg. § 1.199A-5(c)(2). Additionally, if a trade or business has 50% or more common ownership with a SSTB, has shared expenses and the trade or business represents no more than 5% of the gross receipts of the combined trade or business and SSTB, the trade or business will be considered part of the SSTB. Prop. Reg. § 1.199A-5(c)(3).

The Proposed Regulations provide that whether a taxpayer is in the trade or business of being an employee would depend on the status of the employee under common law and applicable statutes regarding the employer-employee relationship. The Proposed Regulations also include anti-abuse rules regarding the improper classification of a worker as an independent contractor to obtain an IRC § 199A deduction. Prop. Reg. § 1.199A-5(d).

d. ***Taxpayer With Taxable Income Above Threshold Amount***. The threshold amount is $157,500 of taxable income, or $315,000 of taxable income for a taxpayer filing a joint return. This threshold is indexed for inflation. IRC § 199A(e)(2).

If a taxpayer's taxable income is above the threshold amount, and the Wage/UBIA Test results in an amount that is less than 20% of the QBI, then the deductible amount determined under IRC § 199A(b)(2), discussed above, is reduced by a formula. Essentially, the deductible amount is 20% of qualified QBI reduced by a percentage based on the taxable income in excess of the threshold amount. The formula phases out the deductible amount until taxable income reaches $50,000 in excess of the threshold amount ($100,000 for a taxpayer filing a joint return). Thus, for 2018, if taxable income exceeds $207,500 ($415,000 for a taxpayer filing a joint return) the deduction under IRC § 199A is unavailable. IRC § 199A(b)(3); Prop. Reg. § 1.199A-1(d)(2)(iv).

There is a second limitation based on the threshold amount that applies to a SSTB, defined above. If taxable income exceeds the threshold amount, only a certain percentage of items of income, gain, deduction or loss, and the W-2 wages and UBIA shall be used in determining the deductible amount, defined above. The percentage is determined by a formula that reduces the percentage based on the amount that taxable income exceeds the threshold amount. Once taxable income exceeds the threshold amount by $50,000 ($100,000 for taxpayer filing a joint return), the deduction is unavailable for the taxpayer's interest in the SSTB. IRC § 199A(d)(3). The taxpayer's interest in a SSTB may be subject to both the phaseout under IRC § 199A(b)(3) and (d)(3). Prop. Reg. § 1.199A-1(d); Raatz, *supra*.

For wages to be taken into account, the associated wage expense for the payer of the wages must be taken into account in computing QBI. IRC § 199A(b)(4); Prop. Reg. § 1.199A-2(b). The IRS has issued a proposed revenue procedure, Notice 2018-64, 2018-35 I.R.B. 347, which provides three methods for calculating W-2 wages.

For purposes of the Wage/UBIA Test, UBIA for qualified property is generally its cost under IRC § 1012 as of the date that the property is placed in service. Prop. Reg. § 1.199A-2(c)(3).

e. ***Qualified Property***. Qualified property, which is taken into consideration in applying the Wage/UBIA Test, is tangible property subject to allowance for depreciation under IRC § 167. The depreciable period for such property must not have ended before the close of the tax year. The property must be held by, and available for use in, the qualified trade or business at the close of the taxable year. The property must be used in the production of QBI. IRC § 199A(b)(6); Prop. Reg. § 1.199A-2(c).

To help prevent property transfers with the principal purpose of increasing the IRC § 199A deduction, the Proposed Regulations contain an anti-abuse rule which provides that property would not be considered qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the IRC § 199A deduction. Prop. Reg. § 1.199A-2(c)(1)(iv).

f. ***Aggregation***. The Proposed Regulations provide rules allowing a taxpayer with interests in related trades or businesses to combine their QBI, W-2 wages and UBIA for purposes of the applying the Wages/UBIA Test. Aggregation is permitted, but not required. In general, the Proposed Regulations provide that aggregation would be permitted if the trades or businesses are under common control, integrated and provide similar products or services. The Proposed Regulations would provide family attribution rules for determining control. Aggregation would be disallowed for SSTBs except as provided above pursuant to Prop. Reg. § 1.199A-5. Prop. Reg. § 1.199A-4.

g. ***Multiple Owners or Beneficiaries***. For entities with multiple owners, each owner is allocated the owner's allocable share of income, losses, basis and other items necessary to calculate the owner's deduction under this section. IRC § 199A(f)(1); Prop. Reg. § 1.199A-2. With respect to a non-grantor trust or estate with multiple beneficiaries, the

Proposed Regulations provide that each beneficiary's portion of the trust's or estate's QBI, W-2 wages and UBIA would be based on the proportion of such beneficiary's portion of distributed net income ("DNI"), with any undistributed DNI used to determine the trust's or estate's QBI, W-2 wages and UBIA. Whether a trust or estate exceeds the threshold amount is determined without considering any distribution deduction. Prop. Reg. § 1.199A-6(d).

h. ***Agricultural and Horticultural Cooperatives***. Special rules apply for income attributable to domestic production activities of specified agricultural or horticultural cooperatives. IRC § 199A(g). The Proposed Regulations do not address these entities. Prop. Reg. § 1.199A-1(a)(1).

i. ***Proposed Regulations Under IRC § 643(f)***. IRC § 643(f) provides that, for purposes of subchapter J of the IRC (IRC §§ 641-685), pursuant to regulations, two or more trusts shall be treated as one trust if: (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and (2) a principal purpose of such trust is the avoidance of the income tax. For purposes of IRC § 643(f), spouses shall be treated as one person. No regulations have been issued under this subsection.

The Proposed Regulations, however, include provisions that would carry out the rule under IRC § 643(f) by preventing taxpayers from dividing trust assets among multiple trusts so that each trust has income below the threshold amount. Prop. Reg. § 1.643-1(f). The Proposed Regulations add that "the application of proposed §1.643(f)-1, however, is not limited to avoidance of the limitations under section 199A and proposed §§1.199A-1 through 1.199A-6."

j. ***Effective Date of the Proposed Regulations***. Most of the Proposed Regulations would apply to taxable years beginning after the Proposed Regulations are finalized. The anti-abuse provisions of the Proposed Regulations, however, would apply retroactively to taxable years ending after December 22, 2017, the date of enactment of the 2017 Tax Act. The regulations proposed under IRC § 643 would apply to taxable years ending after August 16, 2018, the date of publication of the Proposed Regulations in the Federal Register.

5. Charitable Gifts From Electing Small Business Trusts. The 2017 Tax Act also amends prior law to provide that the charitable contribution deduction allowed for the portion of an electing small business trust ("ESBT") holding S corporation stock is determined under the rules applicable to individuals under IRC § 170, and not those applicable to trusts under IRC § 642(c). An ESBT holding S corporation stock is able to avoid the restrictions imposed by IRC § 642(c), including the requirements that the contribution be made pursuant to the trust instrument and be made from gross income. An ESBT may now carry forward excess charitable deductions for five years. However, an ESBT will be subject to the same percentage limitations and substantiation requirements as individuals. The above changes to ESBT's will not sunset.

6. Carried Interests. The 2017 Tax Act imposes a three-year holding period on carried interests before becoming eligible for long-term capital gain treatment. Carried interests are referred to as "applicable partnership interests" and are defined as an interest held in connection with the performance of substantial services by the taxpayer or related persons in an "applicable retained business." IRC § 1061(c)(1). An "applicable retained business" consists of activities conducted on a regular, continuous and substantial basis related, in whole or in part, to (1) the raising or returning of capital and (2) either developing, or investing in or disposing of (or identifying for investing or disposition), assets such as securities, commodities, rental or investment real estate or cash or its equivalent. IRC § 1061(c)(2)&(3).

Applicable partnership interests do not include: (a) a partnership interest held by a corporation and (b) capital partnership interests that provide the partner with a right to share in partnership capital based on the amount of capital contributed or the value of such interest included in income under IRC § 83 upon the receipt or vesting of the interest. IRC § 1061(c)(4).

The new provision applies regardless of the application of IRC § 83. IRC § 1061(a).

Treasury is authorized to promulgate regulations necessary to carry out the provisions of these provisions. IRC § 1061(f); Notice 2018-18, 2018-12 I.R.B. 443 (March 19, 2018).

II. Estate Planning and Estate and Trust Administration After the 2017 Tax Act

A. Many Changes Wrought by the 2017 Tax Act Not Permanent

As detailed above, many tax law changes implemented by the 2017 Tax Act are temporary and, unless new legislation is enacted, will sunset on January 1, 2026. Many planning and administration strategies that make sense under the 2017 Tax Act will become less efficacious, and could even become deleterious, after December 31, 2025. Accordingly, those who draft estate planning documents may be wise in some cases to include alternative provisions to take effect depending on whether particular provisions of the 2017 Tax Act remain in effect when the client dies. In addition, estate planners will need to remain attentive to further changes in the tax laws that may impact the 2017 Tax Act's sunset provisions and to the necessity to change course in some respects if any provisions of the 2017 Tax Act in fact sunset on January 1, 2016.

B. Effect of the 2017 Tax Act on Formula Provisions

A very sizable number of estate plans in now in effect (and, perhaps, still being designed) largely revolve around provisions to take effect at the death of the first spouse to die that would cause property having a value equal to the smallest amount necessary to reduce federal estate tax to zero (or a fractional share of such property defined by a numerator equal to such smallest amount) to pass in a marital deduction disposition with the balance of the decedent's estate to pass in a non-marital deduction disposition. There has always been a legitimate question regarding whether testamentary dispositions of property should be utterly dependent on whether the federal tax law in effect when an estate plan put in place remains in place at a client's death.

The 2017 Tax Act accentuates this issue. Consider the following example: X has a Will containing a formula provision of the type summarized in the preceding paragraph. X signed his Will ten years ago. X's non-marital deduction disposition is materially different from his marital deduction disposition. (There are innumerable clients across America in this estate planning posture.) When X signed his Will or trust instrument, his net worth was $5,000,000. Today, X's net worth is $8,000,000. Ten years ago, in 2008, what we now refer to as the "basic exclusion amount" was $2,000,000. Today, it is $11,180,000. Next year it will be $11,400,000.

Had X died in 2008, $3,000,000 would have passed in the marital deduction disposition, and $2,000,000 would have passed in the non-marital deduction disposition, a result of which X presumably approved. The applicable figures for 2009 would have been $1,500,000 and $3,500,000. The applicable figures for 2010, based on what X and his advisors could have known in 2008, were $4,000,000 and $1,000,000. If X were to die today, his surviving spouse could receive ***nothing*** under his estate plan (whether outright or in trust).

Clients with formula-based estate plans should carefully consider whether those plans would carry out their present intentions and, if not, take steps promptly to make changes needed to conform their plans to achieve the results they want. Furthermore, estate planning advisors should seriously consider in what circumstances, if any, traditional zero-out-the-tax formula provisions make sense any longer (assuming they ever made sense).

C. Provisions Directing Alternative Dispositions

The scheduled, but not 100% certain, expiration on January 1, 2026 of the portion of the 2017 Tax Act providing for a $10,000,000 basic exclusion amount (indexed for inflation) will lead to dramatically different results in terms of how much value can pass, federal estate tax-free, at the death of an individual who survives past December 31, 2025. If the law does not change before January 1, 2026, the basic exclusion amount will decline by several million dollars (likely in the neighborhood of $6,000,000). Anticipating this possibility, clients and their advisors may wish in some cases to design estate plans providing for one dispositive scheme to take effect if the basic exclusion amount at the client's death is equal to or greater than a specified threshold amount and an alternative dispositive scheme if the basic exclusion amount at the client's death is less than such amount.

D. Clayton QTIPs

1. Description and Background. A so-called Clayton QTIP trust is a trust for which a QTIP election at the death of the first spouse to die is eligible to be made and where, to the extent the predeceased spouse's executor does not make the QTIP election, any non-elected property, under the terms of the governing instrument, passes to a separate trust which is not required to have terms identical to the QTIP trust and is not required to meet the definition of a QTIP trust, *i.e.*, a traditional credit shelter-type trust for the concurrent benefit of the surviving spouse and descendants living from time to time.

This planning technique is named after *Estate of Clayton v. Comm'r*, 976 F.2d 1486 (5th Cir. 1992). *See also* Treas. Reg. § 20.2056(b)-7(d) and 7(h). In *Estate of Clayton*, the decedent's will created a family trust and a marital trust. The will provided that, if the executors failed to make a QTIP election with respect to the marital trust, any non-elected potential QTIP property would pass to the family trust. The will also provided that, to the extent the surviving spouse disclaimed any portion of the marital trust, that portion would pass to a third trust with terms similar to those of the family trust. The surviving spouse, as sole Independent Executrix, made a QTIP election for an undivided .563731 interest in specified bonds, notes and cash. The Commissioner disallowed the marital deduction as to the QTIP portion and issued a notice of deficiency. The Court of Appeals for the Fifth Circuit considered the question of whether the effect of the testamentary provision that caused non-elected potential QTIP property to pass in a non-QTIP disposition rendered all potential QTIP property ineligible to be elected as QTIP property in any event. The Fifth Circuit ruled in favor of the surviving spouse and found that the provisions of the will did not affect the deductibility under IRC § 2056(b)(7) of the value of any potential QTIP property with respect to which a QTIP election was actually made because: (1) the property to which IRC § 2056(b)(7) applied was only the property with respect to which a QTIP election was actually made and not all property with respect to which such an election could be made; and (2) the election related back to the decedent's death.

Both the Tax Court and the IRS acceded to the decision of the Fifth Circuit. *See Estate of Spencer v. Comm'r*, 43 F.3d 226 (6th Cir. 1995) and *Estate of Robertson v. Comm'r*, 15 F.3d 779 (8th Cir. 1994). Treas. Reg. § 20.2056(b)-7(d)(3) provides that an income interest which is contingent on the election of the executor will not fail to be a qualifying income interest life if such an election is actually made.

2. <u>Substantial Post-Death Planning Flexibility</u>. In a typical Clayton QTIP scenario, to the extent a QTIP election is not made with respect to a predeceased spouse's residuary estate, non-elected potential QTIP property passes to a traditional credit shelter-type trust for the concurrent benefit of the surviving spouse and descendants living from time to time. Income from that trust does not have to be paid to the surviving spouse. The trust may provide for wholly discretionary income and principal distributions among multiple current beneficiaries. In addition, the surviving spouse may have a non-general power of appointment over the assets of the trust. The surviving spouse must have a mandatory income interest only in the property with respect to which a QTIP election is made.

An executor generally has up to fifteen months (nine-month due date for filing the decedent's Form 706 plus an automatic six-month extension) after the decedent's death to assess the current situation and determine the appropriate QTIP election approach. The executor determines the amount of marital deduction desired relative to the size of the decedent's entire residuary estate. To the extent the executor refrains from making the QTIP election, the executor effectively shifts the disposition of property from a QTIP disposition to a credit shelter disposition. Treas. Reg. §§ 20.2056(b)-7(d)(3) and -7(h), Ex. 6, explicitly allow this technique to be implemented without disallowing causing forfeiture of the marital deduction.

The flexibility allowed in the Clayton QTIP context provides opportunities for tax savings based on asset characteristics, the age and health of the surviving spouse and the family's goals. An executor may elect portability and may make a QTIP election with respect to 100% of potential QTIP property thereby facilitating use of the predeceased spouse's GST exemption by means of the "reverse QTIP election" under IRC § 2652(a)(3) *plus* a full basis step up as to the QTIP property at the death of the surviving spouse. On the other hand, an executor may prefer a traditional credit shelter trust approach which will allow for use of the predeceased spouse's GST exemption without "reverse QTIP election" and will in essence trade estate tax-free appreciation of property during the life of the surviving spouse for basis step-up at the surviving spouse's death.

With a broad discretionary credit shelter trust dispositive scheme, income tax planning potential through the making of judicious distributions abounds. In addition, income tax planning options may be enhanced by providing the surviving spouse with a broad non-general lifetime power of appointment over the credit shelter trust.

A similar result may be achieved by using a contingent disclaimer trust plan. In this scenario, at the death of the first spouse to die, the predeceased spouse's residuary estate is directed to be distributed outright to the surviving spouse (instead of a trust with respect to which a QTIP election could be made). If and to the extent the surviving spouse makes a qualified disclaimer (IRC § 2518), disclaimed property would pass to a credit shelter-type trust for the concurrent benefit of the surviving spouse and descendants living from time to time. Note, however, that, if the surviving spouse were to hold a non-general power of appointment not limited by an ascertainable standard, the disclaimer would not be qualified. Treas. Reg. § 25.2518-2(e)(2). Also, the time within which such a qualified disclaimer may be made is nine months after the predeceased spouse's date of death (IRC § 2518(b)) (as compared to the fifteen-month timeframe after the predeceased spouse's date of death within which a QTIP election decision may be made). In addition, the opportunity to make a qualified disclaimer may be inadvertently tainted by an acceptance of benefits by the surviving spouse before the disclaimer is finalized. IRC §2518(b); Treas. Reg. § 25.2518-2(d)(1).

E. Selected Gifting Considerations

1. Taking Advantage of Enhanced Basic Exclusion Amount. At this time, and for the indefinite future, individuals have a greatly enhanced, historically high basic exclusion amount. This large basic exclusion amount is scheduled to evaporate January 1, 2026, and could be taken away by legislation at any time before that date. Thus, clients having significant wealth who wish to maximize their use of what could be a fleeting opportunity to use the basic exclusion amount now in place should consider expeditiously making one or more lifetime taxable gifts that fully absorb such basic exclusion amount. All the usual advantages of making gifts sooner rather than later would be in play, and, in addition, if the current basic exclusion amount is reduced or expires after such gifts have been made, it appears at least possible that gifts made to use the enhanced basic exclusion amount will not trigger additional estate tax at the donor's death. *See* IRC § 2001(g)(2).

2. "Clawback" Issues. In writing and passing the 2017 Tax Act, Congress essentially "punted" on the question of "clawback." As explained above, IRC § 2001(g)(2) instructs the Secretary of the Treasury to issue regulations to address "clawback." Many commentators assume Congress intended "clawback" not occur, *i.e.*, that a decedent who made large lifetime taxable gifts to use the increased basic exclusion amount while the 2017 Tax Act was in effect and died after the sunset of the 2017 Tax Act should not be treated on his or her estate tax return as having made taxable gifts because the increased basic exclusion amount for estate tax purposes had been eliminated. However, IRC § 2001(g)(2) does not instruct the Secretary to eliminate or prevent "clawback," just to address it.

Even if "clawback" were to apply, an individual who made large lifetime taxable gifts to use the increased basic exclusion amount while the 2017 Tax Act was in effect would still be in a better transfer tax position than if he or she had not made the gifts, except in a case in which the gifted property (or its proceeds) did not increase in value after the date(s) of the gift(s).

3. **Generating Gift Tax.** Particularly in an era of relatively enormous basic exclusion amounts, the vast majority of our clients who make sizeable lifetime gifts will not want to make such gifts in a manner that will cause gift tax actually to be incurred.

F. Selected Basis Considerations

1. **Watch Basis in Making Gifts.** As always, but particularly when contemplating the making of large gifts and selecting the best assets with which to fund such gifts, the cost basis embedded in the assets being considered as the subject of gifts should not be overlooked. In most cases, the making of gifts using low basis assets will be undesirable.

2. **Formula General Powers of Appointment.** Post-2017 Tax Act, not only do many clients anticipate having no estate tax issues, they reasonably believe their children and grandchildren will also have no such issues. Nevertheless, trusts for clients' children and more remote descendants (at least until they reach designated ages) remain as viable and important as ever.

It is possible to design trusts for clients' descendants in a manner that will cause the value of the assets in such trusts to be included in their respective gross estates just up to the point beyond which estate tax would be incurred.

IRC § 2041(b)(1) defines a general power of appointment as a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. IRC § 2041(a)(2) provides that "the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised."

Whether the holder of a testamentary power of appointment chooses to exercise it, the property that was subject to the power will be deemed to have been acquired from the deceased testator and will, therefore, qualify for the step-up in basis. *See* Treas. Reg. §§ 1.1014-2(a)(4), (b)(2). Thus, it is important to consider under what circumstances and to what extent it is wise to confer a general power of appointment with respect to property held in trust to generate basis step-up and income tax savings.

A testamentary general power of appointment can be conferred by means of a formula in such a way that the power would be exercisable only to the extent holding such power would not, by itself, cause imposition of any estate tax. Such a formula could effectively be further refined in such a way so as to have effect only with respect to certain assets in a trust, or to subject to such power, first, those trust assets having the lowest basis and then cascading to each next lowest basis asset until holding the power would no longer not cause any imposition of estate tax.

A trust instrument could also be drafted in such a way that an independent trustee or a trust protector may grant a general power of appointment (perhaps, a formula general power of appointment, as described above) to a beneficiary after having examined the income and transfer tax consequences of so doing. Conditioning the grant of a general power of appointment to the determination of an independent trustee or a trust protector may provide more flexibility than having the trust instrument itself confer the general power of appointment. Consider, however, whether a given independent trustee will have the willingness and sophistication to grant a general power of appointment to a beneficiary and whether such independent trustee will even be available when needed for such purpose.

3. <u>Use Elderly Parents</u>. Wealthy clients with elderly less wealthy parents (even incapacitated less wealthy parents) could consider giving low-basis property to an irrevocable trust for the lifetime benefit of a parent, or selling such property to an irrevocable grantor trust for the lifetime benefit of a parent, in either case naming the client or the client's descendants as remainder beneficiaries and conferring on such parent a narrowly circumscribed formula general power of appointment of the type described above. A client considering this strategy would need to have substantial confidence that the parent would not attempt to divert the property away from the client at the parent's death and that there would be no undue risk under applicable state law that the parent's creditors could gain access to the trust property. In fact, given that an individual is deemed to possess a general power of appointment conferred on him or her even if he or she is unaware of it, an adventurous client without less wealthy parents could use a variation of this strategy with an elderly person who is a perfect stranger as the lifetime beneficiary of such a trust!

G. Installment Sales to Irrevocable Grantor Trusts

A well-known leveraged estate planning strategy involves the creation of an irrevocable grantor trust in connection with an installment sale of assets having good or great appreciation potential to such trust. Virtually all respected estate planning commentators advise that such an installment sale be supported by a gratuitous transfer of additional assets to the trust so that there is a source from which a down-payment on the installment sale may be made (so the transaction bears characteristics similar to those that would exist in an installment sale between unrelated parties) and a source, independent from the assets sold to the trust from which annual interest payments may be made (to minimize the possibility of inclusion in the settlor's taxable estate of the value of trust property under IRC § 2041(a)(2)). Most such commentators suggest such a gratuitous transfer of additional assets be of assets having a value of at least 10% of the value of the assets being sold to the trust.

With an historically high basic exclusion amount, a client could, without incurring gift tax, engage in such a gratuitous transfer to support an installment sale to an irrevocable grantor trust using assets having a value much greater than before the 2017 Tax Act was in place. Using a much larger gratuitous transfer would enable implementing a geometrically larger installment sale, resulting in potentially much greater estate tax savings.

H. Long-Term Trusts

Trusts with a duration as long as applicable state law will permit (which duration in many states is "forever") continue to have all the transfer tax and income tax potential benefits as such trust have had since long before the 2017 Tax Act. With the 2017 Tax Act, clearly the impact of such benefits may be greatly increased. A large gift to a long-term irrevocable grantor trust fully utilizing a client's basic exclusion amount, to which the client's GST exemption is allocated, puts potentially very substantial value in a vehicle that for the indefinite future escapes estate tax, gift tax and generation-skipping transfer tax and enables the fine-tuning of income tax consequences (basis step-up using formula general powers of appointment for beneficiaries and minimizing income taxes for the trust and its beneficiaries after grantor trust status has ended through the making of judicious distributions).

I. Defined Value Clauses

In conjunction with the making of large lifetime taxable gifts to take full advantage of today's basic exclusion amount under the 2017 Tax Act but seeking to avoid the risk of actually incurring gift tax (especially where difficult-to-value assets are involved), the use of defined value clauses in documents effectuating gifts or sales would seem imperative. The Internal Revenue Service appears to despise defined value clauses, having litigated many cases in an effort to have them declared as void due to public policy considerations, but it has been decades since the Service has prevailed in a defined value clause case, and there are several relatively recent cases that provide a virtual roadmap for how to design an effective defined value clause that will almost eliminate the risk of incurring gift tax. *See Estate of Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009); *Estate of Petter v. Comm'r*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (2011); *Wandry v. Comm'r*, 103 T.C.M. (CCH) 1472 (2012).

J. Timing of Expenses Incurred in Estate or Trust Administration

The inclusion of IRC § 67(g) in the 2017 Tax Act notwithstanding, Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018), clearly indicates that, until January 1, 2016 or until applicable law is changed in the interim, estates and nongrantor trusts can take miscellaneous itemized deductions with respect to expenses incurred that are unique to estate or trust administration. What is less clear, however, is whether excess deductions passing through to a beneficiary under IRC § 642(h) in the year in which the estate or trust terminates, to the extent such excess deductions include expenses incurred that are unique to estate or trust administration, may be taken by the beneficiary on his or her personal income tax return. Section 4 of Notice 2018-61 solicits comments from the public regarding this IRC § 642(h) issue. At this time, it is impossible to predict the ultimate resolution of this issue. Accordingly, unless and until this issue is formally resolved in favor of allowing estate and trust beneficiaries to claim the excess deductions on termination, as described above, on their individual income tax returns, fiduciaries of estates and trusts should seek to pay as many expenses unique to estate or trust administration as possible in years preceding the year of termination to the extent there is sufficient taxable income in the estate or trust in such years to be offset by such expenses.

K. Charitable Giving

The TJSA's doubling of the standard deduction, as summarized above, means that many taxpayers who previously found it advantageous to itemize their deductions no longer do. By one rough, unattributed estimate, 30% of taxpayers itemized on their 2017 income tax returns, and, for 2018, that figure will decrease to 8 or 9%.

There are relatively few cases in which taxpayers have flexibility to make or not make, or to impact the timing of, payments that give rise to income tax deductions, but the deduction for charitable contributions is one such case. The freedom when or whether to contribute to charity is virtually unlimited.

1. **<u>"Bunching" of Charitable Contributions</u>.** To maximize the tax deduction impact of making contributions to charity, taxpayers should consider "bunching" their charitable contributions that they would otherwise have made over two or more years into a single year. Following this strategy could produce aggregate itemized deductions in that year in excess of the standard deduction, thereby generating income tax savings in that year that would otherwise have been unavailable in any year if charitable contributions were made evenly over the same number of years that were "bunched."

Some taxpayers may be unable to decide, in the year of "bunching," what charitable organizations they want to benefit from all the dollars they were otherwise anticipating giving to charity over two or more years. For these taxpayers, a donor advised fund may be a good solution. An individual or spouses could make his or her, or their, "bunched" charitable contribution (or a portion thereof) to a donor advised fund, obtain all the same tax benefits available when a contribution is made to a traditional public charity and then, after deciding later what organization they desire as ultimate recipients, communicate his, her or their wishes to the fund manager, who, as a practical matter, will almost always accede to a donor's requests as to ultimate distributees.

2. **<u>Charitable IRA Rollover</u>.** A charitable giving strategy that avoids altogether the impact of the new standard deduction in discouraging itemized deductions (and therefore, perhaps, the making of annual charitable contributions) is the so-called charitable IRA rollover. An individual age 70½ or older can direct charitable gifts to be made from his or her IRA up to a maximum of $100,000 per year. Such charitable gifts come from funds that would, if distributed to the IRA owner, constitute taxable income to him or her. However, since such funds are passing directly to charity, they are not included in taxable income – generating in effect a charitable contribution income tax deduction for the IRA owner. Note, however, that a charitable IRA rollover cannot be made to a donor advised fund.

L. Converting S Corporations to C Corporations

New IRC § 199A, introduced into the law by the TCJA, provides a deduction of 20% for QBI from pass-through entities (with many limitations and qualifications, as described above). IRC § 199A was enacted to give a roughly offsetting income tax benefit to owners of equity of closely held S corporations, partnerships and limited liability companies in recognition of the lowering of the income tax rate for C corporations from 35% to 21%.

It has been suggested that, new IRC § 199A notwithstanding, owners of S corporation stock should consider converting to C corporation status to take advantage of the 21% income tax rate C corporations now enjoy. That recommendation would appear, however, to have less practical utility than might initially appear. An S corporation shareholder who is in the 37% federal income tax bracket and can take full advantage of the 20% deduction would be subject to tax on his or her qualified business income at a 29.6% rate. From that perspective, a 21% rate obviously looks better. However, unlike a C corporation shareholder, that S corporation shareholder will experience no additional income tax by reason of distributions. A C corporation shareholder receiving distributions is subject to double taxation, first at the entity level and then at the shareholder level when distributions are made. So, the C corporation shareholder in the 37% income tax bracket, when both entity level and shareholder level taxes are considered, bears aggregate income taxes totaling 50.23%. When shareholder distributions are considered, the C corporation result (50.23% aggregate federal income taxes) looks much worse than the S corporation result (29.6% federal income tax). Thus, conversion of an S corporation to be a C corporation, in an effort to minimize income taxes in most cases will not make sense except in cases where the corporation plans to retain its earnings for a considerable period.

M. Remedial Measures

1. <u>Note Forgiveness</u>. Clients who have made loans to their children over the years in order to avoid making taxable gifts that would have resulted in incurring gift tax may now consider forgiving those loans. In many situations involving such loans that remain outstanding, loan forgiveness can be accomplished within the parameters of the enhanced basic exclusion amount under the 2017 Tax Act.

2. <u>Allocation of GST Exemption</u>. The 2017 Tax Act, in addition to nearly doubling the basic exclusion amount, also effectively nearly doubled the GST exemption. Clients may be transferors with respect to trusts established in the past that, for some reason, intentional or inadvertent, have an inclusion ratio for generation-skipping transfer tax purposes of greater than zero. Now could be an opportune time for those clients to allocate their larger GST exemption to the extent necessary to reduce inclusion ratios to zero.

3. <u>Trigger Estate Tax Inclusion After-the-Fact</u>.

a. <u>*Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017)</u>. On August 8, 2008, one of the decedent's sons, acting on the decedent's behalf pursuant to a power of attorney, transferred over $10,000,000 in cash and securities from decedent's revocable trust to a family limited partnership (the "FLP") in exchange for a 99% limited partner interest. The FLP was formed by the decedent's two sons two days beforehand. The FLP could be dissolved by agreement of all the partners. The partnership agreement gave the decedent's son who was acting as the decedent's attorney-in-fact sole authority regarding distributions. The decedent died on August 15, 2008.

In the decedent's estate tax proceedings, the Internal Revenue Service issued a notice of deficiency asserting $5,870,226 in tax due. The estate moved for summary judgment, claiming there was no deficiency. The IRS moved for summary judgment as well, asserting that the value of cash and securities transferred from the decedent's revocable trust to the FLP in exchange for a 99% limited partner interest was includable in the value of the decedent's gross estate under IRC § 2036(a)(1).

The Tax Court explained that IRC § 2036 includes the value of transferred property in the value of a decedent's gross estate if, after the transfer (except for a bona fide sale for an adequate and full consideration), the decedent retained the possession or enjoyment of, or the right to the income from, the property (IRC § 2036(a)(1)) or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom (IRC § 2036(a)(2)). This case was reviewed by the entire Tax Court. The Tax Court ultimately sided with the IRS and held that the assets that had been transferred to the FLP were included in the decedent's gross estate under IRC § 2036(a)(2). The Tax Court found that the decedent's power, with her sons, to terminate the partnership, along with the attorney-in-fact's power to determine distributions from the partnership, each constituted a retained right to determine the possession or enjoyment of the transferred property or its income under IRC § 2036(a)(2). The Tax Court referred to its opinion in *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 416 F.3d 468 (5th Cir. 2005), where it relied primarily on two factors to determine whether inclusion in the decedent's gross estate was appropriate. In *Strangi*, like this case, the decedent transferred property to a family limited partnership in exchange for a 99% limited partner interest. The decedent and the other partners could dissolve the family limited partnership and return the transferred property back in the decedent. In addition, like the present case, the decedent, through his attorney-in-fact, had control over partnership distributions. Thus, the Tax Court in *Strangi* concluded that, because the decedent could join together with others to dissolve the partnership and determine the amount and timing of partnership distributions, it was justified to include in his gross estate under IRC § 2036(a)(2) the value of the property he transferred in exchange for the partnership interest.

A decedent's estate in 2018 or a subsequent year through 2025 holding equity in a FLP created years ago (as in *Powell*) may now actually find inclusion in the gross estate to be advantageous. With the enhanced basic exclusion amount provided by the TCJA, estate tax inclusion may cause no estate tax to be imposed but, upon the making a an election under IRC § 754, could result in some basis step-up with respect to the FLP's underlying assets. Accordingly, the executor of such an estate may take the position that the Tax Court's holding in *Powell* ***requires*** the value of ***all*** FLP interests to be included in the gross estate under IRC § 2036, even if the decedent owned no portion of the general partner interest. Following the reasoning of *Powell*, the argument would be that the decedent, in conjunction with all the other partners, could compel termination of the FLP and direct the disposition of its assets.

b. ***<u>Trust Decanting or Modification</u>*****.** Even when the provisions of an existing irrevocable trust instrument would not allow or are affirmatively designed to prevent inclusion of the value of trust property in the gross estate of a beneficiary, there are various mechanisms that may be available under state law by which a general power of appointment could be added to a trust.

Decanting is the process by which a trustee of an irrevocable trust with discretionary distribution authority may, without court approval, transfer the trust property into a new, separate trust. The governing instrument of the new trust has administrative and/or dispositive terms different from those contained in the original trust instrument.

The decanting statutes in the various states whose laws authorize decanting vary widely. Under many such statutes, however, it would be possible (or would certainly appear to be possible) for a Trustee to decant to a new trust whose terms would confer a general power of appointment on a beneficiary, thereby generating basis step-up with respect to the assets of the trust at the beneficiary's death.

Notice 2011-101, 2011-52 I.R.B. 932, requests comments regarding the income, gift, estate and GST tax consequences arising from a decanting that changes a beneficiary's interest. Since the IRS has not yet issued decanting regulations, and has not listed decanting regulations in its latest priority guidance plan (*see* Department of the Treasury, *2017-2018 Priority Guidance Plan*, 4th Quarter Update (August 17, 2018)), any decanting that changes beneficial interests should be undertaken with care.

A result similar to the decanting result described above may also be achieved by means of judicial or non-judicial modification or non-judicial settlement. *See*, *e.g.*, §§ 111, 411, 412 and 416 of the Uniform Trust Code. In addition, under common law, beneficiaries, trustees and any other interested parties effectively often have the power to agree among themselves privately to modify trust terms. Acker, *Modifying, Reforming and Terminating Irrevocable Trusts (the Uniform Trust Code Has Made This Harder!)*, 45TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING, Ch. 10 (2011). In some states and under some circumstances, whether such a modification or settlement could be used to insert a general power of appointment may turn on whether such a change would be considered to violate a material purpose of the trust and could be properly approved by the court.

III. Trusts and Estates-Related Items in IRS Priority Guidance Plan

2017-2018 Priority Guidance Plan, 4th Quarter Update (August 17, 2018)

A. New Guidance and Regulations

The IRS is working on numerous projects arising from the 2017 Tax Act, including the following:

- Additional computational, definitional and anti-avoidance guidance under new IRC § 199A.
- Guidance on computation of unrelated business taxable income for separate trades or business under new IRC § 512(a)(6).
- Guidance implementing changes to IRC § 529.
- Guidance implementing changes to electing small business trusts under IRC § 1361.
- Guidance on certain issues relating to the excise tax on excess renumeration under IRC § 4960.

In addition, the IRS has prioritized issuing guidance on the following issues:

- IRC § 1014 regarding basis of grantor trust assets at death.
- IRC § 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
- Guidance under Treas. Reg. § 301.9100 regarding relief for late regulatory elections.
- A revenue ruling under IRC § 102 regarding whether contributions of money received through a crowdfunding site to pay for medical expenses under IRC § 213 are excludable from income because the contributions are gifts.

The IRS intends to issue regulations on the following issues related to foreign trusts: (a) IRC §§ 6039F, 6048 and 6677 on foreign trust reporting and reporting with respect to foreign gifts; and (b) IRC §§ 643(i) and 679 relating to certain transactions between U.S. persons and foreign trusts.

B. Final Regulations

The IRS intends to issue final regulations under the following provisions:

- IRC §§ 1014(f) and 6035 regarding basis consistency between an estate and a person acquiring property from a decedent.
- IRC § 2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate a GST exemption.
- IRC § 2032(a) on the imposition of restrictions on estate assets during the 6-month alternate valuation period.
- IRC § 509(a)(3) regarding supporting organizations.
- IRC § 529(c)(3)(D) on the recontribution within 60 days of refunded qualified higher education expenses.
- IRC § 529A on qualified ABLE programs.

IV. Transfer Taxation

A. Review of a Predeceased Spouse's Estate Tax Return Allowed For Adjustment of DSUEA

Estate of Sower v. Commissioner, 149 T.C. No. 11 (September 11, 2017)

In *Sower*, a Tax Court addressed the extent of IRS's authority to examine a predeceased spouse's estate tax return, after the statute of limitations for assessing additional tax had expired, to determine whether the Deceased Spouse's Unused Exclusion Amount ("DSUEA") was calculated correctly. The Executor of the estate of the predeceased spouse (Frank) had elected portability and had calculated the DSUEA as $1,256,033. The IRS issued a closing letter to the Executor stating the return had been accepted as filed and further stated that the return would not be reopened unless there was evidence of IRS administrative error.

The surviving spouse (Minnie) died the following year and the Executor of estate filed an estate tax return claiming a DSUEA of $1,256,033 from Frank's estate. Months later, the IRS began a review of the return filed by Minnie's estate. In connection with examining her estate tax return, the IRS also examined Frank's estate tax return and discovered that the preparer had omitted adjusted taxable gifts. Had adjusted taxable gifts been included, the DSUEA would have been about $283,000. The IRS reduced the DSUEA available to Minnie's estate accordingly. The IRS also adjusted Minnie's taxable estate for various other gifts and expenses, which left an estate tax deficiency for her estate of $788,165. Minnie's estate filed a timely petition for redetermination disputing the amount.

Minnie's estate argued the IRS lacked authority to recalculate Frank's DSUEA. First, the court pointed out that the IRS has the power to examine the estate tax return of the predeceased spouse to determine the DSUEA amount, regardless of whether the period of limitations on assessment has expired. The estate also maintained the DSUEA calculation didn't have to take into consideration Frank's lifetime taxable gifts because all such gifts were made before portability was enshrined in the law. The court discarded this point as irrelevant. Next, the estate argued the IRS had essentially waived any right it had to recalculate the DSUEA because Frank's estate had received a closing letter, and the closing letter should be considered a closing agreement as referenced and authorized in IRC § 7121. The court refused to equate a closing letter with a closing agreement under IRC § 7121 and concluded that Frank's DSUEA should be reduced by the aggregate amount of his lifetime taxable gifts. Minnie's estate also argued that reviewing Frank's estate tax return for the DSUEA amount was an improper second examination. However, the court disregarded this point as well. The court held there was no second examination because the IRS did not obtain any new information. Lastly, the court noted that there was no violation of the statute of limitations as to Frank's estate because the IRS did not assess any tax against Frank's estate, it was simply an adjustment of his DSUEA, and the IRS only assessed the tax against Minnie's estate. Ultimately, the court found that the IRS acted within the bounds of its authority when it examined the return filed by Frank's estate to adjust the DSUEA available to Minnie.

B. IRS Provides Simplified Procedure to Obtain Extension of Time to Elect Portability

Rev. Proc. 2017-34, 2017-26 I.R.B. 1282 (June 9, 2017)

The IRS in Revenue Procedure 2017-34, provided a simplified and streamlined procedure for obtaining an extension of time to elect portability. The general rule is that a portability election must be made, if at all, on a timely, complete and properly prepared estate tax return. Treas. Reg. § 20.2010-2(a). Previously, the only method to extend the time for filing to elect portability was to request a private letter ruling under Treasury Reg. § 301.9100-3. This option is expensive, time consuming and not guaranteed.

Under the revenue procedure, the time within which such a return may be filed is extended to the second anniversary of the decedent's death. To qualify, the estate must meet all the following requirements:

- The decedent must have died after December 31, 2010;
- The decedent must be survived by a spouse;
- The decedent must have been a U.S. citizen or resident at death;
- The estate must not have been required to file an estate tax return because of IRC § 6018(a);
- The estate must not have filed the estate tax return timely;
- The estate must file a complete and properly prepared estate tax return; and
- The estate tax return must contain the following language across the top of page one:
  "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

If the estate does not meet all of the above requirements, the only method to request an extension to file for portability is via the private letter ruling procedure.

C. Transfer to Family Limited Partnership Under Power of Attorney Included in Decedent's Gross Estate

Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017)

1. <u>Facts</u>. On August 8, 2008, one of the decedent's sons, acting on the decedent's behalf pursuant to a power of attorney, transferred over $10,000,000 in cash and securities from decedent's revocable trust to a family limited partnership (the "FLP") in exchange for a 99% limited partner interest. The FLP was formed by the decedent's two sons two days beforehand. The FLP could be dissolved by agreement of all the partners. The partnership agreement gave the decedent's son who was acting as the decedent's attorney-in-fact sole authority regarding distributions.

On the same day as the transfer, the decedent's son, acting under the power of attorney, transferred the decedent's 99% limited partner interest to a charitable lead annuity trust ("CLAT"), the governing instrument of which directed the Trustee to pay an annuity to a charity for the remainder of decedent's life and distribute the remainder to the decedent's descendants. The power of attorney, however, permitted gifts only to the principal's descendants and only in amounts that did not exceed the federal gift tax annual exclusion. The decedent died on August 15, 2008.

Decedent's 2008 gift tax return reported the gift to the CLAT of her 99% limited partner interest and reflected a 25% valuation discount for lack of control and marketability. The Internal Revenue Service ("IRS") issued a notice of deficiency asserting $5,870,226 in federal estate tax due and another notice of deficiency asserting $2,961,366 in federal gift tax due. The estate moved for summary judgment, claiming there was no deficiency in the estate or gift tax. The IRS moved for summary judgment as well, asserting that the value of cash and securities transferred from the decedent's revocable trust to the FLP in exchange for a 99% limited partner interest was includable in the value of the decedent's gross estate under Internal Revenue Code ("IRC") § 2036(a)(1) and (2) and that the transfer to the CLAT was invalid because the decedent's son did not have the authority to transfer the interest to a CLAT.

2. <u>Analysis</u>. The Tax Court explained that IRC § 2036 includes the value of transferred property in the value of a decedent's gross estate if, after the transfer (except for a bona fide sale for an adequate and full consideration), the decedent retained the possession or enjoyment of, or the right to the income from, the property (IRC § 2036(a)(1)) or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom (IRC § 2036(a)(2)).

This case was reviewed by the entire Tax Court. The Tax Court ultimately sided with the IRS and held that the assets that had been transferred to the FLP were included in the decedent's gross estate under IRC § 2036(a)(2). The Tax Court further held that the gift of the 99% limited partner interest to the CLAT by decedent's son pursuant to a power of attorney was void or revocable because the decedent's son lacked the authority to make such transfer under applicable state (California) law. Even if the transfer to the CLAT had been valid, the Tax Court determined that the value of the assets would be includable in the decedent's gross estate under IRC § 2035(a) because the transfer to the CLAT was made within three years of the decedent's death and would have been includible in the decedent's gross estate if the transfer had not been made.

The Tax Court found that the decedent's power, with her sons, to terminate the partnership, along with the attorney-in-fact's power to determine distributions from the partnership, each constituted a retained right to determine the possession or enjoyment of the transferred property or its income under IRC § 2036(a)(2). The Tax Court referred to its opinion in *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 416 F.3d 468 (5th Cir. 2005), where it relied primarily on two factors to determine whether inclusion in the decedent's gross estate was appropriate. In *Strangi*, like this case, the decedent transferred property to a family limited partnership in exchange for a 99% limited partner interest. The decedent and the other partners could dissolve the family limited partnership and return the transferred property back in the decedent. In addition, like the present case, the decedent, through his attorney-in-fact, had control over partnership distributions. Thus, the Tax Court in *Strangi* concluded that, because the decedent could join together with others to dissolve the partnership and determine the amount and timing of partnership distributions, it was justified to include in his gross estate under IRC § 2036(a)(2) the value of the property he transferred in exchange for the partnership interest.

The Tax Court then explained the calculation of the includable amount under IRC § 2036, under which the Tax Court traditionally disregards the existence of a FLP and finds that the value of the FLP's assets themselves is included in the decedent's gross estate. Using that approach, there is no concern with double taxation, *i.e.*, subjecting to estate tax <u>both</u> the value of the retained FLP interest <u>and</u> the value of its underlying assets. The Tax Court held that, while interpreting the applicable statutes to avoid double taxation leads to the correct result, the reason for so doing has gone "unarticulated." The Tax Court here chose to "fill that lacuna and explain why a double inclusion in a decedent's estate is not only illogical, it is not allowed." The Tax Court explained that a decedent's gross estate should include, under IRC § 2033, the value of the FLP interest held at date of death (taking into consideration proper valuation discounts) <u>plus</u>, under IRC § 2036(a), the value of the assets that had been transferred to the FLP <u>less</u>, under IRC § 2043(a), the value of the FLP interest the decedent received in exchange for his or her transfer of assets into the FLP (again, taking into consideration proper valuation discounts), determined at the time it was received (not at date of death). Thus, in a case in which values don't change between the date of transfer of assets into the FLP and the decedent's date of death, as here, the <u>net</u> result is that the gross estate includes only the value of the assets held in the FLP at date of death, the expected, if not necessarily fair, result.

In this case, the invalidity of the transfer of the FLP interest to the CLAT caused the entire date-of-death value of the 99% FLP interest to be included in the decedent's gross estate.

The difficulty with the Tax Court's analysis is that, in a case in which asset values <u>increase</u> from the date of transfer of assets into the FLP up until the decedent's date of death, the <u>net</u> result is the double taxation that the Tax Court said is "not allowed." In such a circumstance, the value of the FLP interest held at date of death and included in the gross estate under IRC § 2033 is <u>not</u> fully offset by the subtraction, under IRC § 2043(a), of the value of the FLP interest the decedent received in exchange for his or her transfer of assets into the FLP, <u>determined at the time it was received</u>.

D. IRS Prevails in Summary Judgment Motion Regarding Value of Split-Dollar Arrangements in Decedent's Gross Estate

Estate of Cahill v. Commissioner, T.C. Memo. 2018-84 (June 18, 2018)

1. Facts. In 2010, when the relevant events of this case occurred, Richard F. Cahill was 90 years old and unable to manage his own affairs. His son, Patrick Cahill, served as his attorney-in-fact and as Trustee of Richard's revocable trust, named the Richard F. Cahill Survivor Trust (the "Survivor Trust").

Richard, through Patrick as his attorney-in-fact, established an irrevocable trust titled the Morrison Brown Trust (the "MB Trust"). William Cahill, Patrick's cousin and business partner, served as Trustee of the MB Trust. The MB Trust owned three life insurance policies, one on the life of Patrick's wife, and two on Patrick's life. The aggregate premiums for these policies was $10 million and the total death benefit was $79.8 million.

The Survivor Trust then entered into a split-dollar arrangement with the MB Trust regarding each policy. Under each arrangement, the Survivor Trust was obligated to pay the full premium, which the Survivor Trust financed with an independent lender. Each arrangement provided that, upon the death of the insured, the Survivor Trust would receive a portion of the death benefit equal to the greater of: (1) any remaining balance on the loan related to the policy, (2) the total premiums paid by the Survivor Trust or (3) the cash surrender value of the policy immediately before the insured's death. The remaining proceeds would be paid to the MB Trust.

Each split-dollar arrangement also provided that it could be terminated during the insured's life by written agreement between the Trustees of the Survivor Trust and the MB Trust. Upon termination, if the MB Trust retained the policy, it would be obligated to pay the Survivor's Trust the greater of the total premiums paid or the policy's cash surrender value. If, upon termination, the policy was not retained, then the policy would be transferred to the Survivor Trust's lender in full or partial satisfaction of the Survivor Trust's liability. The MB Trust was not permitted to sell, assign, transfer, borrow against, surrender or cancel the policy without the consent of the Survivor Trust.

Richard filed a gift tax return for 2010 that reported gifts to the MB Trust in an amount equal to the cost of life insurance protection, which was in accordance with the economic benefit regime for the taxation of split-dollar arrangements under Treas. Reg. § 1.61-22.

Richard died on December 12, 2011. Patrick served as executor of his estate (the "Estate"). Upon Richard's death, the total cash surrender value of the policies was $9,611,624. The estate tax return for Richard's estate stated that the value of Mr. Cahill's interest in the split-dollar arrangements totaled $183,700.

The IRS asserted an estate tax deficiency of $6,282,202, along with penalties for negligence or disregard of rules or regulations, for gross valuation misstatements and, alternatively, for substantial valuation misstatements. The IRS adjusted the total value of Richard's rights in the split-dollar arrangements to the aggregate cash surrender value of the policies.

The Estate filed a motion for partial summary judgment, asserting that IRC §§ 2036(a)(2), 2038(a)(1) and 2703(a)(1)&(2) do not apply to this case. The Estate also asserted that the regulations regarding split-dollar arrangements, Treas. Reg. § 1.61-22, does apply in valuing Mr. Cahill's interests in the split-dollar arrangements.

2. Analysis. The Estate contended that the Survivor Trust's interest in the policies upon Richard's death was only equal to his rights in the death benefit, and that the value of the death benefit was worth only $183,700 because the insureds were projected to live for many more years. The Estate asserted that the termination right in the split-dollar arrangement was worthless because it could only be exercised in conjunction with the MB Trust and it would never make economic sense for the MB Trust to allow termination of the split-dollar arrangement.

The Tax Court first determined that the economic benefit regime under the split-dollar regulations applies to the case because the only economic benefit provided to MB Trust was current life protection. Treas. Reg. § 1.61-22(c)(1)(ii). The IRS argued that these regulations only apply for gift tax purposes, not estate tax purposes. Treas. Reg. § 1.61-22(a). Although agreeing with the IRS's reading of these regulations, the Tax Court concluded that, "to the extent that (1) the regulations illuminate the gift tax treatment of transfers arising out of the split-dollar agreements at issue, (2) those transfers are relevant to estate tax issues, and (3) obvious reasons do not compel divergent interpretations of the relevant gift and estate tax Code sections, we shall look to the regulations in deciding this case."

Regarding IRC §§ 2036(a)(2) and 2038(a)(1), the Tax Court explained that the issue was whether the cash surrender value of the policies was includable in the gross estate under these sections. Relying on *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017), summarized above, and *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005), the Tax Court stated that "the rights to terminate and recover at least the cash surrender value were clearly rights, held in conjunction with another person (MB Trust), both to designate the persons who would possess or enjoy the transferred property under section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under section 2038(a)(1)."

The Tax Court also concluded that the exception under both of these provisions for a bona fide sale for adequate and full consideration was not met. The Tax Court stated that "there are many unresolved factual questions with respect to whether this transfer had a legitimate business purpose," and therefore constituted a bona fide sale, rather than a transaction primarily designed to decease the value of Richard's gross estate.

The Tax Court also found that adequate and full consideration was not provided in this arrangement. The Tax Court believed that the circumstances that gave rise to the 98% discount for the cash surrender value claimed by the Estate upon Richard's death also existed at the time the arrangement was entered into a year earlier. Therefore, the Tax Court reasoned that the Estate could not have possibly received full and adequate consideration for the $10 million of life insurance it provided to the MB Trust.

Relying on IRC § 2703(a)(1)&(2), the IRS also argued that the MB Trust's ability to veto termination of the split-dollar arrangements should be disregarded for the purposes of valuing the

Survivor Trust's rights in the split-dollar arrangements. The Tax Court found that IRC § 2703(a)(1) applied here because the split-dollar arrangements allowed the MB Trust to obtain rights in the life insurance policies for less than fair market value. The Tax Court found that IRC § 2703(a)(2) also applied here because the Survivor Trust's ability to terminate the split-dollar arrangements was subject the MB Trust's consent, which therefore was a restriction on the Survivor Trust's ability to exercise this right. The Tax Court added that, for purposes of the summary judgment motion before it, the parties had not addressed the application of IRC § 2703(b), which provides an exception to the application of IRC § 2703(a).

E. Tax Court Denies Summary Judgment Motion Seeking to Avoid the Application of IRC § 2703 to Split-Dollar Arrangements

Estate of Morrissette v. Commissioner, 146 T.C. No. 11 (2016); Order, Docket No. 4415-14 (June 21, 2018)

1. **Facts**. Clara Morrissette ("Clara") established a revocable trust in 1994 ("Clara's Trust") and transferred all of her stock in a group of family-owned companies called the Interstate Group to her revocable trust. Clara was declared incompetent in August 2006, and Cathleen Hatfield was appointed conservator of Clara's estate. Shortly thereafter, Clara's sons - Arthur, Donald and Kenneth - became Co-Trustees of Clara's Trust.

Acting on behalf of Clara, in 2006 Ms. Hatfield established three dynasty trusts (the "Dynasty Trusts") - one for each of Clara's sons and their respective families. On September 19, 2006, Clara's Trust was amended (the "2006 Amendment") to allow the Trustee to pay life insurance premiums on "policies acquired to fund the buy-sell provisions of the [Interstate Group's] business succession plan" and to enter into split-dollar arrangements. The 2006 Amendment also allowed, but did not require, the Trustee to transfer receivables from the split-dollar arrangements back to the Dynasty Trust that owed the receivable or directly to Clara's sons. Two days later, the shareholders entered into a shareholder agreement. The shareholder agreement provided, among other things, that, upon the death of any of Clara's sons, the surviving siblings and their respective Dynasty Trusts would purchase the stock held by or for the benefit of a deceased son.

In October 2006, each Dynasty Trust purchased universal life insurance policies on the lives of the two other siblings (*e.g.*, Arthur's trust purchased policies on the lives of Donald and Kenneth, and so on). At the end of October, Clara's Trust entered into two split-dollar arrangements with each Dynasty Trust. A split-dollar arrangement allows one party to pay the premiums on a life insurance contract and, in exchange, that party is entitled to recover all or a portion of the premiums, which is secured by the life insurance proceeds. Treas. Reg. § 1.61-22(b)(1).

Under the arrangement, Clara's Trust contributed a combined $29.9 million in nearly equal values to each of the Dynasty Trusts. The Dynasty Trusts used the funds to pay lump-sum premium payments on the life insurance policies held in each trust. The arrangements further provided that, upon the death of the insured, Clara's Trust was to receive a portion of the death benefit of the policy equal to the greater of the cash surrender value ("CSV") or the aggregate premium payments on the life insurance policies. The Dynasty Trust would receive the balance of the death benefit, which was then to be used to buy the stock of the deceased son. If the arrangement was terminated during a son's life, Clara's Trust would receive the greater of the CSV or the aggregate premiums paid, and the Dynasty Trust would not receive any funds. The arrangements also contained the following recital:

> WHEREAS, the parties intend that this Agreement be taxed under the economic benefit regime of the Split-Dollar Final Regulations, and that the only economic benefit provided to the [Dynasty] Trust[s] under this arrangement is current life insurance protection.

Neither Clara's Trust nor the Dynasty Trusts retained the right to borrow against the cash value of the policies.

From 2006 to 2009, Clara filed gift tax returns reporting her gifts to the Dynasty Trusts using the economic benefit regime set forth in Treasury Regulation § 1.61-22. The amount reported was the cost of the life insurance protection reduced by the amount of the premiums paid by the Dynasty Trusts. In January 2009, the Co-Trustees, along with the remaining shareholders of the various companies of the Interstate Group, contributed their stock to Interstate Group Holdings, Inc. ("IGH") in exchange for IGH stock.

Clara died on September 25, 2009, and the receivables were valued for inclusion in Clara's gross estate at $7,479,000. The IRS issued a deficiency notice in December 2013 for Clara's 2006 gift tax liability in the amount of $13,800,179 and assessed an accuracy-related penalty of $2,760,036 under IRC § 6662. The IRS took the position that Clara should have reported the full value of $29.9 million on her gift tax returns. The executor filed a petition for redetermination in March 2014. The executor then moved for partial summary judgment as to whether the split-dollar arrangements should be governed under the economic benefit regime. The IRS argued that summary judgment was inappropriate because whether Clara's Trust provided the Dynasty Trusts with an economic benefit other than current life insurance protection was an issue of fact. The Tax Court disagreed.

2. <u>2016 Tax Court Opinion</u>. The Tax Court held that the split-dollar arrangement was a valid contract between Clara's Trust and the Dynasty Trusts, and, accordingly, Clara's Trust was entitled to recover the premiums paid under the arrangement. Pursuant to the Treasury Regulations, split-dollar arrangements are governed under either the loan regime or the economic benefit regime. This determination hinges on who owns the policy, which is typically the owner of the insurance contract. *See* Treas. Reg. § 1.61-22(c)(1). A non-owner is any person other than the owner who has a direct or indirect interest in the insurance contract. Treas. Reg. § 1.61-22(c)(2). This arrangement would treat the Dynasty Trusts as owners, which would mean that the loan regime would apply. The economic benefit rule, however, provides that if the only economic benefit provided under the arrangement is the life insurance protection, the donor will be treated as the deemed owner of the insurance contract and the economic benefit regime will apply. Treas. Reg. § 1.61-22(c)(1)(ii)(A)(2).

Therefore, the primary consideration for the Tax Court was whether the money gifted by Clara's Trust to the Dynasty Trusts for the premium payments provided the Dynasty Trusts with an additional economic benefit in addition to the life insurance protection. If not, then Clara's Trust would be the deemed owner and the economic benefit regime would have applied to her gifts. The value of the economic benefit provided to a non-owner under a split-dollar arrangement is equal to the cost of the current life insurance protection, plus the amount of cash value to which the non-owner has current access, plus any additional economic benefits. Treas. Reg. § 1.61-22(d)(2). The value will be reduced in all events by any consideration provided by the non-owner. Therefore, the Tax Court found that the determination turned on whether the Dynasty Trusts had current access to the cash value of the insurance policies.

A non-owner has current access to the cash value if: (i) the non-owner has a current or future right to all or a portion of the cash value and (ii) that right currently is directly or indirectly accessible by the non-owner, inaccessible to the owner or inaccessible to the owner's creditors. Treas. Reg. § 1.61-22(d)(4)(ii). The Tax Court found that the Dynasty Trusts did not have current access to the cash value because, if the insurance contracts were terminated during life, the entire cash value would have been paid to Clara's Trust. If the contracts terminated as a result of death of the insured, the Dynasty Trusts would have only received the excess death benefit remaining after payment to Clara's Trust of the greater of the aggregate premiums paid or the cash surrender value. The IRS argued that the 2006 Amendment to Clara's Trust gave the Dynasty Trusts a direct or indirect right to the cash value because any amount paid to Clara's Trust would pass either to the Dynasty Trusts or directly to the sons pursuant to the provisions of Clara's Trust. The Tax Court disagreed, stating that Clara retained the right to amend or revoke the trust during her lifetime and the split-dollar arrangement itself did not require such a distribution of the receivables. In fact, the agreement was silent as to their disposition.

The IRS, relying on Notice 2002-59, 2002-36 I.R.B. 481, argued that the circumstances addressed there regarding reverse split-dollar arrangements forbade the use of the economic benefit regime. The Tax Court said that reverse split-dollar arrangements differed from the transaction between Clara's Trust and the Dynasty Trusts because it did not attempt to take advantage of an out-of-date rate schedule to provide an influx of cash to the Dynasty Trusts to capitalize on the difference between the actual insurance cost and the published schedule. Instead, Clara wanted the company stock to remain in the family and devised the split-dollar plan to achieve that goal while remaining within the requirements of the Treasury Regulations.

3. <u>Summary Judgment Motion Regarding IRC § 2703(a)(2)</u>. After the Tax Court opinion filed its 2016 opinion, the executor filed a petition for partial summary judgment asserting that IRC § 2703 does not apply for purposes of valuing Clara's property rights under the split-dollar arrangements.

IRC § 2703(a)(2) provides that the value of property is determined without regard to any restriction on the right to sell or use the property. Furthermore, the value of any property transferred between family members is determined without regard to any restrictions on the sale or use of the property.

The split-dollar arrangements could be terminated only upon the mutual agreement of Clara's Trust and the respective Dynasty Trust (the "Termination Restriction"). The executor argued that IRC § 2703(a)(2) did not apply to the Termination Restriction. The executor further argued that Clara only held the right to proceeds upon the insured's death, and that right was not subject to any restriction to which IRC § 2703 could apply. The IRS argued that IRC § 2703 applied to the Termination Restriction, and added that Clara's Trust and the Dynasty Trusts entered into agreements regarding the assignment of the policies to Clara's Trust and those agreements contained other restrictions that were also subject to IRC § 2703.

Relying on *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018), summarized above, the Tax Court found that the Termination Restriction was subject to IRC § 2703(a)(2) and denied the summary judgment motion. In addition to preserving the issues under IRC § 2703 for trial, the Tax Court further stated that the IRS's claims that the split-dollar arrangements are includible in Clara's gross estate under IRC §§ 2036 and 2038 also remain to be determined at trial.

F. Estate Tax Deduction Disallowed for Gift Tax Paid by Donees

Estate of Sommers v. Commissioner, 149 T.C. No. 8 (August 22, 2017)

1. **Background.** Decedent transferred artwork to an LLC and subsequently made valid gifts of the LLC units to his nieces. In accordance with the agreements governing their gifts, the nieces paid the gift tax due on those gifts. Decedent later initiated litigation against his nieces challenging the validity of the purported gifts and seeking return of the artwork. That litigation ultimately upheld the validity of the gifts.

Upon examination of Decedent's estate tax return, IRS made the following adjustments: (1) the IRS included in Decedent's gross estate, pursuant to IRC § 2035(b), the gift tax resulting from the gifts to Decedent's nieces because Decedent had made those gifts less than three years before his death; (2) the IRS excluded from Decedent's gross estate the value of the artwork that Decedent had transferred to the LLC; and (3) the IRS reduced the marital deduction due to the IRS's determination that the estate tax liability resulting from the inclusion of the gift tax from the gifts to decedent's nieces would have to be paid with marital assets.

2. **Tax Court Decision.** Petitioners, which included Decedent's surviving spouse as well as a temporary administrator of Decedent's estate, argued that the inclusion of the gift tax in Decedent's gross estate should be offset by a deduction in the same amount for gift taxes owed by Decedent's estate at death. The Tax Court held that the estate was not entitled to deduct gift tax owed at Decedent's death on gifts made to his nieces before he died because Decedent's nieces agreed to pay any gift tax arising from those gifts. The estate's payment of that tax would have given rise to a right of reimbursement from Decedent's nieces that must be taken into account in determining Decedent's taxable estate.

Petitioners argued that the estate was entitled to a marital deduction equal to the value of Decedent's nonprobate property that his surviving spouse received or to which she succeeded that, under New Jersey law, was exempt from the estate's debts and expenses. The Tax Court determined that even when marital assets would be exempt from debts and expenses under state law or the terms of the decedent's will, Executors may be forced to sell those assets to satisfy debts and/or pay expenses if nonmarital assets are insufficient. In such cases, the marital deduction must be reduced by the value of the marital assets used to pay debts or expenses.

The New Jersey estate tax apportionment statute, N.J. Stat. Ann. section 3B:24-2, provides for the apportionment of federal estate tax "among the fiduciary and each of the transferees interested in the gross tax estate." Further, "transferee" is defined as "any person to whom the gross estate or any part thereof is, or may be, transferred or to whom any benefit therein accrues other than that part of the gross estate that passes under the will of decedent." The Tax Court interpreted the New Jersey apportionment statute as providing for the apportionment of federal estate tax only to transferees who receive nonprobate property included in the decedent's gross estate. The Tax Court noted that even though the amount of gift tax paid on Decedent's gifts of LLC units was included in Decedent's gross estate, the LLC units themselves were not. Accordingly, no portion of any estate tax could be apportioned to Decedent's nieces.

The Tax Court noted that, based on the record before it, it was unable to determine the extent to which the estate tax would reduce the value of the marital share of Decedent's estate. The Tax Court denied Petitioners' motion for partial summary judgment that any federal estate tax owed by Decedent's estate must be apportioned to Decedent's nieces and could not reduce the marital deduction to which the estate is entitled under IRC § 2056(a).

G. Loan to Pay Estate and GST Taxes Unnecessary; Interest Expense Not Deductible

Estate of Koons v. Commissioner, 686 Fed. App'x. 779 (11th Cir. April 27, 2017), *aff'g* T.C. Memo. 2013-94

1. **Background.** Before his death, Decedent operated Central Investment Corp. ("CIC"), a corporation which primarily bottled and distributed Pepsi products and also sold vending machine items. Decedent, via his Trust, owned 46.9% of CIC's voting stock and 51.5% of its nonvoting stock. Decedent's children owned most of the remaining stock, either directly or through trusts, while other family members and trusts held the remaining shares.

CIC and PepsiCo, Inc. became involved in a dispute that ultimately settled and resulted in PepsiAmericas, Inc. acquiring CIC's soft-drink and vending machine businesses for $352,400,000 and paying an additional $50,000,000 as part of the settlement. Decedent planned to place the settlement proceeds in CI, LLC, to be invested in new businesses operated by professional advisors. The CI, LLC membership interests would be distributed to the CIC shareholders in proportion to their interests in CIC. Decedent's children were displeased with Decedent's plan and conditioned the sale of their CIC shares on receiving an offer from CI, LLC to redeem their interests in CI, LLC. Following the close of the redemption offers, Decedent's Revocable Trust held a 70.93% interest in CI, LLC.

Upon Decedent's death, the majority of the estate's assets consisted of the Trust, with the Trust's interest in the LLC being its primary asset. The estate's remaining liquid assets were insufficient to pay its estate tax liability. The Trustees declined to direct a distribution of the Trust's interest in CI, LLC to pay the tax liability, believing that immediate payment would hinder the LLC's plan to invest in operating businesses. Instead, the Trustees obtained a loan from the LLC in exchange for a promissory note.

The IRS issued a notice of deficiency to the Estate for estate tax and a notice of deficiency to the Trust for GST tax due to its determination that the interest payment was not deductible and that the return understated the value of the Trust's interest in CI, LLC. The United States Tax Court consolidated the two cases.

2. Tax Court Decision. The Tax Court considered the Personal Representative's challenge to the notices of deficiency of estate and GST taxes. It held that the estate was not permitted to deduct the interest expense on the loan from CI, LLC to the Revocable Trust because the loan was not necessary to the administration of the Estate. The LLC had significant liquid assets, and the Revocable Trust had a sufficient voting interest to force a pro rata distribution in the amount of the debt. The Tax Court granted judgment in favor of the IRS, and the Personal Representative appealed.

3. 11th Circuit Affirms. The United States Court of Appeals for the Eleventh Circuit affirmed the U.S. Tax Court's decision. The 11th Circuit agreed that the Trust had authority to order a pro rata distribution from assets in the Trust under Ohio law. Therefore, it had access to sufficient funds to enable it to pay the estate and GST tax liability without violating its fiduciary duty, as long as minority interest holders benefited equally. Interest expense from the loan to pay estate and GST taxes was not deductible because the loan was not necessary within the meaning of Treas. Reg. § 20.2053-3(a), which requires the expense to be actually and necessarily incurred in the administration of the decedent's estate, and had no economic benefit aside from a tax deduction. The 11th Circuit noted that courts were not required to defer to the Executor's business judgment in evaluating the necessity of a loan. Finally, the 11th Circuit held that the Tax Court did not err in determining the fair market value of the Trust's interest in CI, LLC.

H. District Court Concludes That GRAT Assets Were Includable in Gross Estate and Regulation Under IRC § 2036 is Valid

Badgley v. United States, Case No. 17-cv-00877-HSG, 2018 WL 2267566 (N.D. Cal. May 17, 2018)

Patricia Yoder owned a 50% partner interest in a family partnership that owned commercial real estate. In 1998, Ms. Yoder created a grantor-retained annuity trust (the "GRAT") and transferred to the GRAT, without consideration, her interest in the partnership and commercial real estate. Ms. Yoder was the annuitant under the GRAT. The GRAT instrument provided that the annuity term would end upon the earlier of 15 years or the date of Ms. Yoder's death. If Ms. Yoder failed to survive the trust term, the remaining annuity payments and the portion of the GRAT assets includible in Ms. Yoder's gross estate would be paid to a survivor's trust created under Ms. Yoder's revocable trust instrument. Ms. Yoder served as sole Trustee. For each year at issue, the income generated by the partnership interest and distributed to the GRAT was sufficient to fund Ms. Yoder's annuity payments.

Ms. Yoder died in 2012, one year before the termination of the GRAT term. Ms. Yoder's estate (the "Estate") filed this action to challenge the inclusion of the full value of the GRAT assets in the gross estate under IRC § 2036. Both parties filed motions for summary judgment.

Pursuant to IRC § 2036(a)(1), the government asserted that Ms. Yoder retained "the right to the income from" the property she transferred to the GRAT because of her right to the annuity payments. The government also asserted that Ms. Yoder retained the "possession or enjoyment of" the property she transferred to the GRAT under IRC § 2036(a)(1) because of her control over the activities of the partnership.

The Estate asserted that there is no statutory or judicial authority for the proposition that a fixed-term annuity payable out of transferred property constitutes the possession, enjoyment or right to income under IRC § 2036(a)(1). The Estate believed that this annuity interest is not the same as a "right to income" under IRC § 2036(a)(1) and that therefore Ms. Yoder's interest in the GRAT was not within the scope of the statute.

Although the District Court agreed that no authority equates a fixed-term annuity with a "right to income" or "possession or enjoyment" under IRC § 2036(a)(1), it stated that "the U.S. Supreme Court has adopted a substance-over-form approach that favors a finding that Patricia's annuity comprises some possession, enjoyment, or right to income from the transferred property," *citing Helvering v. Hallock*, 309 U.S. 106 (1940); *Commissioner v. Church's Estate*, 355 U.S. 632 (1949); *Spiegel's Estate v. Commissioner*, 335 U.S. 701 (1949). The District Court explained that the language of the statute has been broadly interpreted, and that technical distinctions based on property law are not dispositive of whether the statute applies. The District Court also stated that IRC § 2036 was enacted to prevent taxpayers from avoiding estate tax through lifetime transfers that were testamentary in nature, and that concluding that an annuity right is not covered by IRC § 2036(a)(1) would circumvent that intent. The District Court therefore found that an annuity right and a right to income were not distinct for purposes of IRC § 2036. The District Court further concluded that Ms. Yoder's access to income from the partnership constituted the retained "possession or enjoyment" of the transferred property.

The Estate also argued that this regulation was overly broad and invalid to the extent it applies to the GRAT. Although IRC § 2036 does not expressly refer to an annuity right, the regulations under this section interpret this section as causing an annuity right to trigger inclusion in the gross estate. Treas. Reg. § 20.2036-1(c)(2)(i) states that it "applies to a grantor's retained use of an asset held in trust or a retained annuity . . . including without limitation . . . a grantor retained annuity trust (GRAT) paying out a qualified annuity interest within the meaning of §25.2702-3(b) . . .." The District Court stated that the primary issue to resolve was whether the regulation was "arbitrary or capricious in substance, or manifestly contrary to the statute." *Mayo Found. For Med. Educ. & Research v. United States*, 562 U.S. 44 (2011). The District Court reviewed the Treasury Decision promulgating this regulation and concluded that it was a reasonable interpretation of IRC § 2036 and therefore valid.

This case is on appeal the United States Court of Appeals for the Ninth Circuit.

I. Guidance Relating to the Use of an Account Transcript as a Substitute for an Estate Tax Closing Letter

Notice 2017-12, 2017-5 I.R.B. 742 (January 6, 2017)

This Notice provides guidance on the ability to confirm the closing of an examination of an estate tax return through an online account transcript issued by the IRS. The account transcript serves as a substitute for an estate tax closing letter and can be obtained without charge.

Prior to June 1, 2015, the IRS issued an estate tax closing letter for every return filed, except when a return was filed for the sole purpose of making a portability election and the election was denied. After June 1, 2015, the IRS changed its policy to issue estate tax closing letters only at the request of an estate.

The new account transcript is a computer-generated report that provides account information, such as: the return received date, payment history, refund history, penalties assessed, interest assessed, balance due with accruals and the date on which the examination was closed. An account transcript that includes the transaction code "421" and the explanation "closed examination of tax return" indicates the IRS examination is complete. The return may still be reopened where there is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of material fact; a clearly-defined, substantial error based on an established IRS position; or another circumstance indicating that a failure to reopen the case would be a serious administrative omission. Rev. Proc. 2005-32, 2005-23 I.R.B. 1206. A return for a decedent may also be reopened for the purpose of determining the transfer tax liability of the surviving spouse of that decedent when portability has been elected.

As of May 10, 2018, executors, local probate courts, state tax departments and others can now obtain estate tax transcripts online at www.IRS.gov by searching for "estate tax closing letters" and then selecting "Transcripts in Lieu of Estate Tax Closing Letters." Practitioners still have the option to request estate tax closing letters if required by states, financial institutions or other entities by contacting the IRS no earlier than four months after filing the estate tax return.

V. Income Taxation

A. Tax Residency Statute Violated Due Process Clause When Applied to Trust With Insufficient Connections to the State

Fielding v. Commissioner of Revenue, 2018 WL 3447690 (Minn. July 18, 2018), *aff'g*, 2017 Minn. Tax LEXIS 28 (Minn.T.C. 2017)

1. __Facts__. Reid V. MacDonald ("Grantor") formed four grantor trusts in 2009 (the "Trusts"), while domiciled in Minnesota. The Trusts were funded with shares of common stock in Faribault Foods, Inc., a Minnesota Subchapter S corporation. The Trustee, trust administration, and all but one of the beneficiaries of the Trusts were always located outside of Minnesota.

In 2011, Granter gave up the power to substitute trust assets, and the Trusts became irrevocable. Under Minnesota Statute § 290.01, subd. 7b(a)(2), Minnesota law defines a "resident trust," in part, as "an irrevocable trust, the grantor of which was domiciled in this state at the time it became irrevocable." At the time the Trusts became irrevocable, the Grantor was domiciled in Minnesota.

On August 1, 2014, the Trustee sold the stock held by the Trusts, resulting in substantial deposits in each of the Trusts' accounts. Under the trust terms, the Trustees made distributions to each beneficiary during 2014. Each Trust timely filed a 2014 Minnesota income tax return as a Minnesota "resident trust" and paid the reported tax under protest, including a statement asserting that the statutory definition of a "resident trust" was unconstitutional. Each Trust then filed an amended 2014 Minnesota income tax return without treating itself as a Minnesota "resident trust," and requested a refund.

2. Analysis. The Trustee argued that Minnesota's definition of a "resident trust" violated the due process provisions of the Minnesota and United States constitutions.

Due process analysis imposes two constraints on state taxation. There must be both "a minimum connection" between a state and the person, property or transaction subject to tax and a rational relationship to the benefits conferred on the taxpayer by the State. *Luther v. Commissioner of Revenue*, 588 N.W.2d 502 (Minn. 1999). The Court found that the statute failed the due process analysis for three reasons.

First, the Court held that the Grantor's residence at the time the trusts became irrevocable was "not relevant to the relationship between the Trusts' income that Minnesota seeks to tax and the protection and benefits Minnesota provided to the Trusts' activities that generated that income. The relevant connections are Minnesota's connection to the trustee, not the connection to the grantor who established the trust years earlier." Thus, the Court looked largely to the trusts' independence as a legal entity, separate from the grantor or beneficiary. *See Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947).

Second, the trusts owned no physical property in Minnesota that might serve as a basis of taxation. *See, e.g., Westfall v. Dir. of Revenue*, 812 S.W.2d 513 (Mo. 1991). The trusts owned interests in intangible property (the stock of a Minnesota company), but those intangible assets were held outside the state of Minnesota.

Third, the Court did not find any contacts with Minnesota by the grantor, the trusts or the beneficiaries, that occurred prior to the tax year at issue to be relevant. Citing Luther, the Court found that the relevant facts for evaluating the sufficiency of a taxpayer's contacts are drawn from the tax year at issue.

B. State Statute That Taxed Trust Income Solely Based on Residence of Beneficiary Violates Due Process Clause As Applied

Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue, 814 S.E.2d 43 (N.C. June 8, 2018), *aff'g*, 789 S.E.2d 645 (N.C. App.2016)

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

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

From 2005 to 2008 the Kaestner Trust's assets were held by a custodian in Boston, Massachusetts. The ownership documents for some of the assets were located in New York, along with financial and legal records. Tax returns and trust accountings were all prepared in New York. The Kaestner Trust provided that all income and principal distributions from the trust were in Bernstein's discretion. Neither Kaestner nor her children received distributions from the Kaestner Trust between 2005 and 2008. However, two loans were made from the Kaestner Trust during the same period: a $250,000 loan was made to Kaestner for an investment and another loan was made to a separate trust "to enable [the trust] to make a capital call on a limited partnership interest" held in that trust. Both loans were eventually repaid to the Kaestner Trust. Kaestner and Bernstein communicated regularly regarding Kaestner's need for distributions and investment of the trust assets. In 2009, Bernstein transferred the Kaestner Trust assets to a new trust, the KER Family Trust.

Each year, from 2005 to 2008, the North Carolina Department of Revenue (the "State") taxed the Kaestner Trust on its income. The Kaestner Trust paid the taxes and sought a refund for the taxes paid, which the State denied in 2011. Section 105-160.2 of the North Carolina statutes provides, in relevant part, that the state may tax the income of a trust "that is for the benefit of a resident of [North Carolina]." The Kaestner Trust sued, alleging that this statute was unconstitutional under the Due Process and Commerce Clauses of the United States Constitution as well as Article I, Section 19 of the North Carolina Constitution. The Commerce Clause argument was not addressed at the Court of Appeals, and is therefore not addressed in the Supreme Court decision.

2. **Analysis**. The Due Process clause requires "some definite link, some minimum connection, between a state and a person, property or transaction [the government] seeks to tax." *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). In addition, the income attributed to the State for tax purposes must be rationally related to values connected with the taxing state. *Id*. "[I]t is essential in each case that there be some act by which the [party] purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws." *Skinner v. Preferred Credit,* 638 S.E.2d 203, 210-11 (N.C. 2006).

The Court found it critical here that a trust is a legally independent entity from its beneficiary, and that in this situation, it was the trust beneficiaries, and not the trust, that were North Carolina residents. Given the separate legal entities, the Court found that the beneficiaries' contact with North Carolina was insufficient to satisfy due process.

The Court chose not to follow two cases in alternate jurisdictions that held differently. In Connecticut, the Court in Chase Manhattan Bank v. Gavin held that taxation of an *inter vivos* trust did not violate due process because the beneficiary was a Connecticut domiciliary. 773 A.2d 782 (Conn. 1999), *cert. denied*, 528 U.S. 965. The Court in *McCulloch v. Franchise Tax Board* found similarly that taxation of the trust was permissible when the beneficiary was a California resident. 390 P.2d 412 (Cal. 1964). The Court in *Kaestner* noted these decisions and found them unpersuasive due to the failure to consider the separate legal existence of the trust in the analysis, and imputing a benefit received by the beneficiary to the trust.

The Department of Revenue also argued that Bernstein restructured the trust at Kaestner's request, and communicated with her regarding management of the assets. The Department of Revenue argued that this indicated a continuing relationship with a North Carolina resident. The Court found that the communication was infrequent, the meetings were held outside the state of North Carolina, and the restructure occurred after the years at issue. The Court reiterated that the trust, not the beneficiary, would have to avail itself of the benefits and protections of the state to satisfy the requirements of due process.

C. Trust Reformation Permitted in Order to Qualify as Grantor Trust

PLR 201807001 (November 13, 2017)

1. <u>Background</u>. Between the dates of September 19, 1995 and August 20, 1996 and with the assistance of an attorney, Donor established a trust which he intended to qualify as a grantor trust. The Trust permitted distributions to Donor and the issue of Donor during Donor's life. In addition, the trust agreement authorized the Independent Trustees, with approval of a court of competent jurisdiction, to reform any provisions of the trust agreement so that burdensome tax consequences may, consistent with the purpose of the Trust and trust agreement, be eliminated or minimized. Donor, Donor's spouse and Donor's issue were not, and had never been, citizens or residents of the United States.

IRC § 672(f)(1) generally provides that the grantor trust provisions apply only to the extent such application results in an amount, if any, being currently taken into account in computing the income of a citizen or resident of the U.S. or a domestic corporation. IRC § 672(f)(2)(A)(ii), however, provides that the general rule of IRC § 672(f)(1) does not apply to any portion of a trust if the only amounts distributable during the lifetime of the grantor are amounts distributable to the grantor or grantor's spouse.

IRC § 672(f)(1) was effective on the date of enactment, August 20, 1996, but grandfather rules were provided for certain trusts that were in existence on September 19, 1995, to the extent any transfers to such trusts were made on or before that date. Accordingly, Donor was treated as the owner of any portion of the Trust over which Donor retained the powers or interests described in IRC §§ 673 through 677 prior to August 20, 1996. Donor was prevented from being the owner of the Trust by operation of IRC § 672(f) as of August 20, 1996 and thereafter because Donor's issue were beneficiaries of the Trust during Donor's life.

2. <u>Trust Reformation</u>. Donor filed a suit to reform the Trust to satisfy the terms of IRC § 672(f)(2)(A)(ii). Both Donor and the attorney who drafted the trust agreement testified regarding their intent for the Trust to qualify as a grantor trust. The court modified the trust agreement by removing "the issue of Donor" as beneficiaries during Donor's lifetime. The court concluded that the original trust agreement was drafted based on what became a mistake of fact and law. Reforming the Trust to delete the inclusion of Donor's issue as beneficiaries of the Trust during Donor's lifetime would correct the mistake of fact and law and conform the trust agreement to Donor's intent.

The IRS concluded that the reformation of the Trust was consistent with applicable state law that would be applied in the highest court of the state and, accordingly, that the Trust's reformation would be taken into account as of the date of formation for the purpose of determining whether the Trust fell within the IRC § 672(f)(2)(A)(ii) exception to IRC § 672(f)(1).

VI. Trust and Estate Administration

A. Trustee Did Not Violate Duty Regarding Distributions and Compensation

Gorby v. Aberth, 81 N.E.3d 910 (Ohio Ct. App. 9th Dist. Summit County January 25, 2017)

1. Facts. Testator died on April 6, 2012, survived by two adult children (the "Plaintiffs"). Defendant in this case was Testator's longtime attorney, who Testator named as the Executor of his Will, and successor Trustee of Testator's Trust (the "Trust").

Testator's Will was admitted to probate in May 2012. The Will directed the majority of any outstanding assets to the Trust. Plaintiffs are the income beneficiaries of the Trust. This suit arose out of Plaintiff's contention that Defendant committed a serious breach of trust warranting his removal as Trustee. Specifically, Plaintiffs allege Defendant failed to (1) distribute income on a quarterly or more frequent basis as required under the Trust, (2) keep them reasonably informed and promptly respond to their requests for information, (3) inform them regarding his compensation; (4) comply with the annual reporting requirements under IRC § 5808.13(C) and (5) use his special skills as an attorney in his capacity as Trustee as required under IRC § 5808.06.

The court acknowledged that Defendant first made distributions of income to Plaintiffs on November 7, 2012, seven months after Testator's death. The court also acknowledged a delay in Defendant's first annual report, which was filed 18 months after Testator's death.

2. Analysis. The court found that the delay in the initial distribution of trust funds the Plaintiffs was caused by Defendant's choice to wait until the statute of limitations on a will contest had expired. The court found that this delay was "prudent and in the best interest of the trust," even though the Trust was given discretion to pay estate debts but not obligated to do so, and therefore the delay did not constitute a breach of trust.

The delay in filing the first annual report was also acceptable, as the Plaintiffs were supplied with statements from the Trust accounts, which contained all of the information required by the annual report.

The court also found that oral advisement of Defendant's hourly rate, following with the indication that Defendant was inclined to bill at the rate of $225 an hour, was sufficient communication of Defendant's compensation.

Finally, the court held that Defendant appropriately used trust funds to compensate himself and the law firm hired to defend this action, and that it was not a breach of trust to hire his firm to defend the action.

B. Trustee Did Not Breach Fiduciary Duty Where Stock Portfolio Lost Value During Financial Crisis

In Re Estate of Joseph Grahek, 2017 Pa. Super. Unpub. LEXIS 1618 (April 27, 2017)

Joseph Grahek created testamentary trusts for the benefit of his wife, Marion, during her life, then for the benefit on his two sons, David and Phillip. The trust's asset was income-producing property in Orange County, California, which was sold in 2006 under threat of eminent domain from the Orange County School District. The Trustee intended to reinvest the sale proceeds in like-kind property to avoid capital gains tax. The goal was to purchase a replacement property that would generate sufficient income to cover the mortgage. The Trustee invested $2.1 million of the sale proceeds of the property in money market accounts, and invested the remaining $6.5 million in a stock portfolio. Before the Trustee was able to purchase a replacement property, the financial crisis of 2008 hit and the trust's stock portfolio lost some of its value. David and Phillip petitioned to remove the corporate Trustee and agreed to serve as Trustees *pro tem*. During this time, they purchased two replacement properties and did not pay capital gains tax.

David and Phillip subsequently filed suit in the Orphans' Court, arguing that the Trustee was obligated to keep all funds from the sale of the original property liquid and available to purchase a replacement property, and that the Trustee was therefore liable for the market losses during the 2008 financial crisis. The court found no breach of fiduciary duty; the Trustee met its legal obligations and sufficiently provided for the interests of the income and remainder beneficiaries, and that the 2008 financial crisis was unforeseeable. On appeal, the Superior Court affirmed and adopted the Orphans' Court opinion in its ruling.

C. Court Approves Decanting of Trust Assets Subject to a Withdrawal Right

Ferri v. Powell-Ferri, 72 N.E.3d 541 (Mass. March 20, 2017); 326 Conn. 438 (August 8, 2017); *Powell-Ferri v. Ferri*, 326 Conn. 457 (August 8, 2017)

The Paul John Ferri, Jr. Trust, dated June 24, 1983 (the "1983 Trust"), was established by Paul John Ferri for the sole benefit of his son, Paul John Ferri, Jr. ("Paul"). The 1983 Trust was governed by Massachusetts law. The 1983 Trust directed the Trustee to "pay to or segregate irrevocably" trust assets for Paul. Paul held a power to withdraw only a percentage of trust assets.

Paul married Nancy Powell-Ferri in Connecticut, and she filed for divorce in 2010. In March 2011, the then acting Trustees of the 1983 Trust, Michael J. Ferri and Anthony J. Medaglia, created the Declaration of Trust for Paul John Ferri, Jr. (the "2011 Trust") and distributed substantially all of the assets of the 1983 Trust to themselves as the Trustees of the 2011 Trust (the "decanting") with no consent from, or notice to, Paul. It was clear the purpose for the decanting was to protect the trust assets from being divided and distributed in the pending divorce action. The Trustees created the 2011 Trust as a spendthrift trust. The Trustees of the 2011 Trust had complete authority over whether and when to make payments to Paul, barred Paul from receiving distribution of trust assets on demand and shielded the trust from Paul's creditors. The terms of the 1983 Trust did not include a provision specifically allowing the Trustees to decant the trust property. When the Trustees created the 2011 Trust, Paul had a right to withdraw 75% of the 1983 Trust assets. During the course of the legal proceedings, this right matured to 100% of the trust assets.

In August 2011, the Trustees sought a declaratory judgment that they validly exercised their powers to decant and distribute the trust assets to the 2011 Trust and that Powell-Ferri had no right, title or interest in the 2011 Trust assets. The Trustees also filed an affidavit by Paul John Ferri, the settlor of the 1983 Trust, to state his intent in forming the trust.

Powell-Ferri filed a motion for summary judgment, which was granted by the Connecticut Superior Court, which then ordered the Trustees to restore 75% of the 2011 Trust assets to the 1983 Trust. *Ferri v. Powell-Ferri*, 2013 Conn. Super. LEXIS 1938 (2013); 2014 Conn. Super. LEXIS 1377 (2014).

Because Massachusetts law applied and the matter could not be resolved by reference to Massachusetts statutes and case law, the Connecticut Supreme Court certified the following three issues to the Supreme Judicial Court of Massachusetts: (1) whether the terms of the 1983 Trust empowered the Trustees to decant to the 2011 Trust; (2) if not, whether 75% or 100% of the 2011 Trust assets be returned to the 1983 Trust to restore the status quo; and (3) whether a court can consider an affidavit of the settlor in determining whether the settlor intended to permit a decanting.

1. <u>Supreme Judicial Court of Massachusetts Opinion</u>. During its examination of the facts of this case, the Supreme Judicial Court of Massachusetts considered its decision in *Morse v. Kraft*, 992 N.E.2d 1021 (Mass. 2013), where it allowed the Trustee to decant, even absent explicit authorization to do so. There, the court relied on the Trustee's broad powers in the trust instrument and specifically recognized that there is no inherent power allowing a Trustee to decant. The court in *Ferri* noted that decanting has the effect of "'amend[ing] an unamendable trust, in the sense that [the trustee] may distribute the trust property to a second trust with terms that differ from those of the original trust. The rationale underlying the authority to decant is that if a trustee has the discretionary power to distribute property to or for the benefit of the beneficiaries, the trustee likewise has the authority to distribute the property to another trust for the benefit of those same beneficiaries.'" Quoting *Morse v. Kraft*, 992 N.E.2d 1021 (Mass. 2013). The court in *Morse* also noted that considering the intent of the settlor to give the Trustee this authority is "paramount."

Massachusetts does not have a decanting statute, so the court reviewed the statutory language of several states allowing decanting. The court noted that, in states that have enacted decanting legislation, in general, the authority to decant would be contingent on very broad discretion on the part of the Trustee. In the present case, the court recognized the Trustee's extremely broad discretion throughout the trust instrument. The Trustee could, as long as Paul is living, "pay to or segregate irrevocably" to Paul so much of the net income and principal of this trust as the Trustee deemed desirable for Paul's benefit and take any steps and do any acts in connection with the care, management and disposition of the property and income of the trust without order of court. The court noted the language of the 1983 Trust was almost identical to that in *Morse*, where the court found there was the authority to decant and found that the settlor intended to convey to the Trustee almost unlimited discretion to act. Thus, the court concluded that the settlor's intention to authorize decanting seemed to "follow necessarily."

The *Ferri* court also rejected Powell-Ferri's argument that the Trustees should not be permitted to decant because decanting conflicted with Paul's power to withdraw trust property. The court noted that a Trustee holds full legal title to all property of a trust and the rights of possession that go along with it. By the time of the decanting, Paul had withdrawn only a small portion of the trust assets, so the court noted that the remaining assets were still subject to the Trustee's "authority and stewardship." In addition, the court asserted that the methods for distribution of trust assets did not limit the Trustee's decanting authority. The court noted that, if the settlor had intended to bar decanting after Paul obtained withdrawal rights at age 35, the trust instrument would not have allowed the irrevocable sequestration of assets so long as Paul was living.

The court also found that the settlor's affidavit could be used to provide evidence of the settlor's intent, if used to resolve any ambiguity regarding the settlor's intentions at the time he created the 1983 Trust and not to contradict or vary the terms of the trust.

However, the court did not consider whether Massachusetts law permits Trustees to decant to a new spendthrift trust (from an existing non-spendthrift trust) for the sole purpose of removing trust assets from the marital pot during a divorce. (Citing Gants, C.J. concurring opinion).

2. <u>Connecticut Supreme Court Opinions</u>. The Supreme Court of Connecticut adopted the decision of the Supreme Judicial Court of Massachusetts. Powell-Ferri argued that, since Paul had the power to withdraw 75% of the trust assets at the time of the decanting, the 2011 Trust was effectively a self-settled trust, and the 2011 Trust assets should be subject to division as a marital asset. The court ruled that, since the decanting was carried out without any involvement or knowledge of Paul, the 2011 Trust could not be considered a self-settled trust under Connecticut law.

Although the assets in the 2011 Trust could not be considered marital assets for purposes of the dissolution proceeding, the court did consider the trust assets in determining the amount of Paul's alimony payments.

D. Court Finds That Trustees Breached Duty of Impartiality by Decanting
Hodges v. Johnson, 2017 N.H. LEXIS 232 (N.H. December 12, 2017)

Two irrevocable trusts were established in 2004 for the benefit of the grantor's wife, children, step-children and other descendants. The Trustees had a discretionary power to "distribute all or any portion of the net income and principal of the trust to any one or more of the group consisting of [the beneficiaries] and distributee trusts, in such amounts and at such times as the Trustee, in the Trustee's discretion, may determine." "Distributee trusts" were defined as any trust under the trust instruments or any other trust established by the grantor. A distributee trust could be for the benefit of one or more, "but not necessarily all," of the beneficiaries.

The Trustees of the two irrevocable trusts decanted trust assets into new trusts and eliminated the grantor's two step-children and one of his biological children from the definition of "descendants" in the new trust instruments, effectively stripping their interests in the trusts.

The trust assets were not transferred to the new trusts. The decanting documents provided for the transfer of trust assets upon the settlor's death. Because the parties never made arguments regarding the failure to transfer the assets, both the trial court and the Supreme Court of New Hampshire treated the decantings as if they had occurred when decanting documents were executed and that the failure to transfer assets did not render the decantings invalid.

Under New Hampshire's decanting statute, if a Trustee has the power to make discretionary distributions of principal to one or more beneficiaries, the Trustee may decant the assets to a new trust that eliminates one of those beneficiaries as a beneficiary of the new trust. The statute further provides that "[i]n exercising the power to decant, a trustee has a duty to exercise the power in a manner that is consistent with the settlor's intent as expressed in the terms of the trust, and the trustee shall act in accordance with the trustee's duties under this chapter and the terms of the first trust." RSA 564-B:4-418.

The trial court set aside the decantings and removed the Trustees. On appeal to the Supreme Court of New Hampshire, the court stated that even though New Hampshire's decanting statute allowed the Trustees to eliminate beneficiaries, and even though the Trustees had the discretion to distribute income and principal in the Trustees' discretion, the Trustees were still subject to the duty of impartiality in carrying out the decanting. The court stated that "a trustee, who makes unequal distributions among beneficiaries and/or eliminates a beneficiary's non-vested interest in an irrevocable trust through decanting, violates the statutory duty of impartiality only when the trustee fails to treat the beneficiaries 'equitably in light of the purposes and terms of the trust.'" (quoting Uniform Trust Code § 803 Cmt.).

The court agreed with the trial court that the decantings were improper and void because the decantings violated the Trustees' duty of impartiality by failing to consider the interests of all of the beneficiaries, both present and remainder.

E. Court Upholds Decanting Carried Out Pursuant to Trust Terms

Matter of Hoppenstein, 2017 N.Y. Misc. LEXIS 1707 (N.Y. Surr. March 31, 2017); 2017 N.Y. Misc. LEXIS 3851 (N.Y. Surr. October 10, 2017)

Reuben Hoppenstein created an irrevocable trust in 2004 (the "2004 Trust"). The Trustee was authorized to distribute income to Hoppenstein's descendants. Regarding the distribution of principal, the governing instrument of the 2004 Trust stated that the Trustees may distribute principal, including the entire principal, to Hoppenstein's descendants. Distributions could be made in equal or unequal amounts and could exclude certain descendants in favor of other descendants. The Trustees could make these determinations regarding principal in the Trustees' sole discretion. The 2004 Trust instrument specifically authorized a distribution to a beneficiary to be applied "by payment to a trust for his or her benefit."

After the 2004 Trust was established, Hoppenstein's relationship with one of his daughters soured. Hoppenstein created another irrevocable trust in 2012 (the "2012 Trust"). The 2012 Trust instrument excluded the daughter as a beneficiary. Later in 2012, the Trustees transferred a life insurance policy held by the 2004 Trust to the 2012 Trust.

The daughter and her children objected to the transfer on numerous grounds, including that the transfer did not meet the requirements of New York's decanting statute, NY EPTL 10-6.6. The court stated that this argument was immaterial because the Trustees did not rely on the statute for authority to transfer the life insurance policy, but rather relied on their authority to make discretionary distributions of principal. In addition, the decanting statute specifically provides the statute "shall not be construed to abridge the right of any trustee to appoint property in further trust that arises under the terms of the governing instrument of a trust . . .."

The beneficiaries also held *Crummey* withdrawal rights under the 2004 trust. The beneficiaries argued that, at the time the policy was transferred to the 2012 Trust, the beneficiaries still held unexercised rights of withdrawal over trust assets, which gave them vested rights in the policy that should have prevented the decanting. The court, however, discussed a calculation of the value of each beneficiary's right of withdrawal from the time that the 2004 Trust was established until the policy was transferred and determined that the all of the beneficiaries' rights of withdrawal had lapsed by the time the policy was transferred. The court also rejected the beneficiaries' argument that certain rights of withdrawal never lapsed because they never received a *Crummey* notice, relying on *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209.

F. Court Upheld Modification of Trusts to Directed Trusts and Transfer of Trusts to Delaware

Beardmore v. JP Morgan Chase Bank, N.A., 2017 Ky. App. LEXIS 60 (Ct. App. March 31, 2017)

1. <u>Facts</u>. JP Morgan Chase Bank, N.A. ("JP Morgan") was the Trustee of two trusts created by John G. Stoll ("Mr. Stoll"). Mr. Stoll died in 1959. Mr. Stoll's trusts provided for his children and their descendants until 21 years after the death of Mr. Stoll's children and issue living at the time of his death. By the time this litigation arose in 2014, there were 28 income beneficiaries and 133 living contingent beneficiaries, and it was expected that the trusts would continue for another 50 years.

The Trustee filed motions in the probate division of Fayette District Court to reform the trusts into directed trusts by creating a Family Trust Committee, which would direct the Trustee on all trust decisions. The Trustee also sought to transfer the place of administration to Delaware, where they could take advantage of more favorable tax laws. Of the 151 beneficiaries at the time the action was filed, 143 of them formally consented and one contingent beneficiary, James Beardmore ("Mr. Beardmore") objected.

Following Mr. Beardmore's objection, the Trustee filed a motion for declaration of rights in Fayette Circuit Court and a hearing was scheduled one month later. Prior to the hearing, the Uniform Trust Code ("UTC") was enacted in Kentucky, which placed jurisdiction of the matter in probate division of the Fayette District Court. The Trustee then filed a notice relating to the court's jurisdiction with respect to the UTC, stating that this did not alter the court's jurisdiction over the case and that the circuit court continued to have jurisdiction over this matter. Following a hearing on this issue, the circuit court ultimately retained jurisdiction of the matter, noting that return to the district court would "substantially interfere with the effective conduct of the juridical proceedings and would prejudice the rights of the parties."

The circuit court determined that it would modify the trusts and that even with the adoption of the UTC, the circuit court had the power to modify the trusts when the modification would further the purpose of the trust to the extent practicable. The circuit court found that Mr. Stoll's intent was to "maximize the income to the beneficiaries by whatever legal means necessary." The circuit court thus modified the trusts to create directed trusts and authorized the transfer of the trusts to Delaware. Mr. Beardmore's appeal followed.

2. <u>Analysis</u>. On appeal, the Court of Appeals upheld the directed trust provisions and the transfer of the trusts to Delaware. The Court of Appeals found that jurisdiction of the matter in circuit court was proper because the case was initiated prior to the enactment of the UTC and transferring the case to probate court would cause unnecessary expense and delay. The Court of Appeals also agreed that with the Trustee that Kentucky law permits trusts to be modified to directed trusts. Here, modifying these trusts to create directed trusts would formalize the Family Trust Committee to use third-party advisors for trust investments. Further, the court noted that Mr. Stoll could not have anticipated trust administration through a directed trust at the time he created the trust because that strategy did not exist during his life. Next, the Court of Appeals found that Kentucky law permits the change in the principal place of administration of the trusts. The court stated that transferring the trusts to Delaware would accomplish Mr. Stoll's intent to maximize income to the beneficiaries, in that it would offer them substantial tax savings, and this was a legitimate reason to move the trusts.

G. Court Rejects Modification of a Trust to Remove Trustee

In Re Trust Under Agreement of Taylor, 164 A.3d 1147 (Pa. July 19, 2017)

1. <u>Facts</u>. In this case, the court considered the interplay between 20 Pa.C.S.A. § 7740.1 (regarding modifications of a trust) and 20 Pa.C.S.A. § 7766 (regarding removal of Trustees), part of the Uniform Trust Act, which provide as follows:

> **§7740.1. Modification or termination of noncharitable irrevocable trust by consent**
>
> **(b) Consent by beneficiaries with court approval.** – A noncharitable irrevocable trust may be modified upon the consent of all the beneficiaries only if the court concludes that the modification is not inconsistent with a material purpose of the trust.
>
> **(d) Consent by some beneficiaries with court approval.** -- If not all the beneficiaries consent to a proposed modification or termination of the trust under subsection (a) or (b), the modification or termination may be approved by the court only if the court is satisfied that:
>
> (1) If all the beneficiaries had consented, the trust could have been modified or terminated under this section; and
>
> (2) The interests of a beneficiary who does not consent will be adequately protected.

§7766. Removal of trustee

> **(b) When court may remove trustee.** -- The court may remove a trustee if it finds that removal of the trustee best serves the interests of the beneficiaries of the trust and is not inconsistent with a material purpose of the trust, a suitable cotrustee or successor trustee is available and:
>
> (1) The trustee has committed a serious breach of trust;
>
> (2) Lack of cooperation among cotrustees substantially impairs the administration of the trust;
>
> (3) The trustee has not effectively administered the trust because of the trustee's unfitness, unwillingness or persistent failures; or
>
> (4) There has been a substantial change of circumstances. A corporate reorganization of an institutional trustee, including a plan of merger or consolidation, is not itself a substantial change of circumstances.

Edward Winslow Taylor ("Mr. Taylor") created a trust for his daughter, Anna, and her children. Mr. Taylor named The Colonial Trust Company as corporate Trustee. Several decades later, and after a series of mergers, Wells Fargo became the corporate Trustee in 2009. Wells Fargo sought court approval to divide the trust into four separate and equal trusts for Anna's surviving grandchildren. The Orphans' Court approved the request.

In 2013, three of the surviving grandchildren petitioned the Orphans' Court to modify the trust to add a provision giving themselves the authority, without court approval, to remove and appoint corporate Trustees at their discretion, pursuant to 20 Pa.C.S.A. § 7740.1 which provides consenting beneficiaries with the power to remove a Trustee without court approval. Wells Fargo opposed the petition and moved for judgment on the pleadings, arguing that the Trustees must be removed in accordance with 20 Pa.C.S.A. § 7766 which requires court approval. The Orphans' Court agreed with Wells Fargo and found that the beneficiaries could not use the broad modification powers provided in section 7740.1(d) to eviscerate section 7766 and therefore "must yield to the specific removal provisions in section 7766."

The Superior Court reversed the decision of the Orphans' Court and ruled that the beneficiaries of the trust could modify the terms to permit them to replace the corporate Trustee. The Supreme Court of Pennsylvania then granted discretionary review to determine whether the Superior Court erred in holding that beneficiaries may amend the terms of a trust to permit the removal of a Trustee without court approval.

2. <u>Analysis</u>. The Supreme Court of Pennsylvania reversed the Superior Court and ruled against the grandchildren beneficiaries' request to reform the trust. The Supreme Court concluded that the UTA does not permit the removal and replacement of a Trustee without Orphans' Court approval. In making its ruling, the court concluded that, when reading section 7740.1 in conjunction with section 7766, ambiguities exist. The court noted that there are two plausible interpretations of the plain language of the two provisions. The corporate Trustee may be removed, and replaced, only pursuant to section 7766. So a modification pursuant to 7740.1 to add a portability provision would essentially circumvent the requirements for removal and replacement of the Trustee in section 7766. Because of these ambiguities, the Court determined that the sections must be construed in such a way that one section does not nullify the other. Here, permitting beneficiaries to modify a trust agreement pursuant to section 7740.1 to add a portability clause would have precisely this effect; to "nullify, exclude or cancel" the effectiveness of section 7766. To obtain a modification under section 7740.1 to permit beneficiaries to remove and replace a Trustee, the beneficiaries need only show that the modification would not be inconsistent with a material purpose of the trust. On the other hand, to remove and replace a Trustee pursuant to section 7766, beneficiaries must demonstrate substantial evidentiary hurdles and the court must make numerous findings of fact and conclusions of law. The court held that the scope of section 7740.1 of the UTA does not extend to modification of trust agreements to permit the removal and replacement of Trustees.

H. Settlor of Irrevocable Trusts Prohibited From Unilaterally Modifying Trusts Where Such Action is Reserved for the Trustee or Beneficiaries of the Trusts

Millstein v. Millstein, 2018 Ohio App. LEXIS 2493 (June 14, 2018)

Norman Millstein ("Norman") is the grantor of two irrevocable trust agreements, created in 1987 and 1988, established for the benefit of his children. One of Norman's children, Kevan Millstein ("Kevan") is the sole Trustee of the trusts and one of the beneficiaries of one of the trusts. Norman stated that the trusts were designed under the "grantor trust" rules, so that he would personally report the federal taxable income, deductions and credits from the trust assets, but he would have no rights as a beneficiary of the trusts. In 2010, Norman requested that Kevan reimburse him from the trusts for "substantial income taxes owed on the taxable income generated by the trusts." Kevan declined, but reached an agreement whereby the assets of a third, unrelated trust would be used to pay Norman's tax liabilities. In 2013, Kevan informed Norman that the third trust did not have any further liquid assets with which to pay the income tax liabilities. Norman alleged that Kevan arranged for Norman to no longer be taxed on the income of the trusts beginning in 2014. Norman stated that he paid $5,225,837 in federal and state income taxes arising in 2013 for the trust under which Kevan was a beneficiary, and $1,261,068 for the tax liability arising in 2013, 2014 and 2015 from the other trust Norman established. Norman then requested "equitable reimbursement of income taxes" from the trusts. Kevan and the other trust beneficiaries moved to dismiss Norman's petition. The trial court granted the motions to dismiss.

On appeal, the court ruled the trial court correctly dismissed Norman's petition for failure to state a claim upon which relief can be granted because the relief he sought was outlined under the Ohio Trust Code in R.C. 5804.16 entitled "Modification to achieve settlor's tax objectives." Pursuant to R.C. 5804.10, a Trustee or beneficiary, but not a settlor, may commence a proceeding to approve or disapprove a modification under R.C. 5804.16. The court found Norman did not bring this action under the Ohio Trust Code and was precluded from unilaterally seeking modification to achieve his tax objectives. The court noted that "[n]o court may employ equitable principles to circumvent valid legislative enactments," *citing Lorain Cty. Bd. Of Commrs. v. United States Fire Ins. Co.*, 610 N.E.2d 1061 (Ohio App. 9th Dist. 1992); *Patterson v. Lamson*, 12 N.E. 531 (Ohio 1887); *Seven Hills v. Cleveland*, 439 N.E.2d 895 (Ohio App. 8th Dist.1980). Here, the legislature clearly considered the circumstances where it intended to allow parties to a trust to modify the terms of a trust to achieve a settlor's tax objectives and decided to reserve the power to initiate such action to the Trustee or beneficiary.

I. Financial Institution Did Not Owe a Duty to a Person Who Was Neither a Customer Nor a Person with a Special Relationship to the Institution

Wolens v. Morgan Stanley Smith Barney, LLC, 155 A.3d 1 (N.J. Super. Ct. February 8, 2017)

Kathleen Wolens appealed a trial court's order granting summary judgment dismissing her complaint against Morgan Stanley Smith Barney ("Morgan Stanley"), and her mother's account manager. Kathleen's claim was that Morgan Stanley acted negligently in carrying out a written request from her mother, Patricia, to have Patricia's investment accounts changed from being held solely in her mother's name to jointly with one of Kathleen's sisters, Deirdre. As a joint account holder, Deirdre obtained a right of survivorship in the account's funds, which totaled $847,162, if Patricia predeceased her.

Patricia died in 2008, and because the account funds were treated as a non-probate asset, the funds were transferred to Deirdre. Kathleen contested the transfer of funds, claiming that Patricia had been unduly influenced by Deirdre. Kathleen claimed that defendants acted negligently in allowing the account to be changed without adhering to Morgan Stanley's internal protocol and procedure, which required the obtaining of more information from the relevant parties and the parties' signature on Morgan Stanley's account documents.

The appellate court affirmed the trial court because it was not shown that defendants owed or breached any legal duty to Kathleen, as she was neither a customer of Morgan Stanley nor a person with whom they had a contractual or special relationship. Kathleen presented no federal or state statute, regulation or codified provision that would impose such a duty on a non-customer, nor did she point to any published industry standard or expert support for such an obligation. It is insufficient to rely solely on a financial institution's own internal regulations and procedures. The court further noted that if, in fact, Patricia was subjected to Deirdre's undue influence in writing the letter, she likely would have been subjected to the same undue influence in signing Morgan Stanley's required account documents and the account changes would have resulted anyway.

J. Court Finds That Attorney-Client Privilege Did Not Apply to Communications Regarding Trust Administration

Fiduciary Trust International of California v. Klein, 9 Cal.App.5th 1184 (Cal. Ct. App. March 21, 2017)

1. <u>Facts</u>. This case involves one of a series of conflicts in a highly contentious trust administration. Defendants are the former Trustees of the Mark Hughes Family Trust (the "Trust"), who were removed by court order for breach of trust related to the failure to exercise reasonable prudence in the sale of a trust asset. Plaintiff is the current Trustee. During Defendants' tenure as Trustees, the Trust beneficiary filed a series of objections to Defendants' trust accountings.

After Defendants were replaced by Plaintiff as Trustee, Plaintiff served Defendants' counsel with a demand for the Trust records. Defendants objected to this demand on the grounds of attorney-client privilege. This dispute relates to a probate court order which allowed Defendants to withhold some, but not all, of a collection of documents identified on a privilege log related to two trust accountings that took place during Defendants' tenure as Trustees. Plaintiff objected to the assertion of the attorney-client privilege, stating that said privilege transferred to Plaintiff when Plaintiff became Trustee.

2. <u>Analysis</u>. The purpose of the attorney-client privilege is to safeguard the confidential relationship between clients and their attorneys so as to promote full and open discussion of the facts and tactics surrounding legal matters. *Costco Wholesale Corp. v. Superior Court*, 47 Cal.4th 725 (Cal. 2009). The privilege is absolute and precludes disclosure of confidential communications even though they are highly relevant to a dispute. *City of Petaluma v. Superior Court*, 248 Cal.App.4th 1023 (Cal. 2016). However, the party claiming the privilege has the burden of showing that the communication was made in confidence. Evid. Code § 953, subd. (a). Moreover, where a Trustee is asserting the privilege, the "client" is the office of Trustee rather than the particular Trustee. *See Moeller v. Superior Court*, 16 Cal.4th 1124 (Cal. 1997).

The court in *Moeller* drew an important distinction between confidential communications when a Trustee sought the attorney's advice for guidance on administering the trust, and confidential communications where the Trustee sought legal advice in its personal capacity out of concern regarding possible future charges of breach of fiduciary duty. Specifically, the privilege in the former category transfers to successor Trustees. In contrast, for the latter, the Trustee may be able to "avoid disclosing the advice to a successor trustee by hiring a separate lawyer and paying for the advice out of its personal funds."

Plaintiff argued that all Trustee communications with attorneys are presumed to transfer to successor Trustees unless the previous Trustee took affirmative steps to distinguish the purported personal advice from the advice obtained in a fiduciary capacity. The court agreed, stating that an affirmative burden to distinguish the privileged information in a proactive manner is consistent with the underlying principle that the party claiming privilege bears the burden to establish the facts necessary to support the use of privilege. In particular, the court disapproved of a "hindsight" characterization of communication as defensive. The court emphasized language from *Moeller* requiring a "trustee to distinguish, scrupulously and painstakingly, his or her own interest from those of the beneficiaries" is entirely consistent with the purpose of a trust.

The court also emphasized that the Probate Code places a duty on successor Trustees to make reasonable inquiry into the predecessor's trust administration and remedy any breaches, or be subject to liability for unreasonably allowing the breach to continue or failure to redress. To make this inquiry, the successor Trustee must have access to the trust's legal files. The court found that this policy consideration supported a presumption that attorney-client privilege transfers to the successor Trustee.

K. Trust, Not Grantor, Owned Limited Partner Interest

Schinazi v. Eden, 792 S.E.2d 94 (Ga. Ct. App. 2016)

1. **Facts.** Grantor established an irrevocable trust (the "Trust"), reserving the right to reacquire property by substituting property of equivalent value. Two days after creating the Trust, Grantor formed a limited partnership and assigned his partner interest to the Trust. Six years later, Grantor sent Trustee, Carol Lynn Eden, who was known as "Carol Lynn Schinazi" when the events underlying the appeal first began, a promissory note in an attempt to substitute said promissory note for the limited partner interest. Grantor asked Trustee to acknowledge, in writing, that Grantor was now the sole owner of the partner interest formerly owned by the Trust. The Trustee refused to sign the acknowledgment, asserting that the promissory note did not constitute a substituted asset of equivalent value.

Trustee sought declaratory judgment that the Trust, rather than Grantor, owned the limited partner interest and also asserted claims for failure to tender assets of equivalent value, breach of fiduciary duty, litigation expenses and punitive damages. The trial court held that the Trust still owned the partner interest and granted summary judgment to Trustee on that claim, but the trial court awarded summary judgment to Grantor on the remaining allegations.

2. **Failure to Reacquire Limited Partnership Interest.** The Georgia Court of Appeals held that Grantor failed to follow the necessary steps to reacquire the limited partner interest. Pursuant to the terms of the partnership agreement, the Trust was considered a limited partner when Grantor sought to reacquire the limited partner interest. A limited partner interest could only be transferred after compliance with the transfer procedures set forth in the partnership agreement and the execution of the appropriate transfer form. Grantor did not provide evidence that the parties executed the necessary transfer form.

The Georgia Court of Appeals also held that the trial court erred in granting summary judgment on the breach of fiduciary duty claim and claim for damages, as material questions of fact remained.

L. Timely Filed Renunciation of Decedent's Will Does Not Abate if Surviving Spouse Dies Before the Decedent's Estate is Distributed

In re Estate of Scherr, 81 N.E.3d 131 (Ill. App. June 28, 2017)

1. **Facts.** The decedent, Marjorie Friedman Scherr, died on September 5, 2015. The decedent's Will, which was executed in 1970 during decedent's first marriage, named decedent's children from her first marriage (Respondents) as the sole surviving legatees. After decedent's death, her spouse, George Scherr (George), filed a petition for probate and letters. Because the Executors predeceased the decedent, George nominated the Trustee of his trust to be named Executor, after which the court appointed the Trustee as Administrator with Will Annexed. On April 1, 2016, George filed a renunciation of the Will and assigned his interest in the decedent's estate to his earlier-created trust. George died on May 23, 2016. A copy of the renunciation was sent to Respondents' attorney following George's death. On June 23, 2016, Respondents filed an objection to the renunciation. The circuit court found that allowing the renunciation would violate Illinois public policy and sustained the objection. The Trustee appealed the circuit court's decision to the Appellate Court of Illinois, Second District.

2. Analysis. The Trustee's appeal relied primarily on the plain language of section 2–8 of the Probate Act of 1975 (Act). *See* 755 ILCS 5/2–8. Respondents raised three arguments in opposition: (a) Illinois public policy underlying section 2–8 of the Act indicates that a right to renounce abates upon death, (b) any action created by statute abates upon the death of the party bringing the action unless there is a statutory provision that provides for its survival and (c) the Trustee lacked standing to assert George's renunciation, because the right to renounce is personal and not assignable.

a. Section 2–8 of the Act. The Appellate Court acknowledged that where the plain language of a statute is not ambiguous, the statute must be applied as written without resorting to external aids of construction. Citing *Moore v. Green*, 848 N.E.2d 1015 (Ill. 2006). Section 2–8 of the Act, in pertinent part, provides that a surviving spouse may renounce a decedent's will by "fil[ing] . . . a written instrument signed by the surviving spouse and declaring the renunciation" in the court in which the decedent's will was admitted to probate. 755 ILCS 5/2–8(b). Section 2–8 further provides that the filing "is a complete bar to any claim of the surviving spouse under the will." In its interpretation of the statute, the Appellate Court found that the plain language of Section 2–8 was clear and not ambiguous as to the operative act (*i.e.*, filing of a document renouncing a will) necessary to accomplish a renunciation. Because the statute was clear and not ambiguous, an inquiry into Illinois public policy concerning the purpose of section 2–8 was not necessary. Therefore, the Appellate Court held that the renunciation of a will is complete and perfected, without judicial action or approval, when a surviving spouse complies with all the steps specified in section 2–8 of the Act, and the surviving spouse's subsequent death is irrelevant.

b. Abatement. Under Illinois law, any cause of action created by statute does not survive, and abates upon the death of the party bringing the action, unless that statute or any other provides for its survival. Citing *Creighton v. County of Pope*, 54 N.E.2d 543 (Ill. 1944). Because Section 2–8 of the Act requires nothing beyond filing to perfect a renunciation, George's renunciation was perfected on the date it was filed. After acknowledging that a renunciation may be challenged and undone, the Appellate Court held that a renunciation is complete and, if it survives any challenge, effective as of the date the renunciation was filed.

c. Assignment and Standing. The Appellate Court found that George's right to renounce was exercised in accordance with Section 2–8 of the Act before his death. Thus, George did not assign his right to renounce, but assigned only the interest he possessed after his right to renounce was exercised. Accordingly, the Trustee did not lack standing to assert George's renunciation.

VII. Charitable Giving

A. Tenth Circuit Holds That Trust's Charitable Deduction is Limited to the Adjusted Basis of Contributed Property

Green v. United States, 880 F.3d 519 (10th Cir. January 12, 2018)

Mart Green, the Trustee of the David and Barbara Green 1993 Dynasty Trust (the trust) filed an action seeking a refund of federal income taxes paid by the trust in 2004 and contesting the amount of the charitable deduction that the trust could take in connection with its donation of three parcels of real property. The trust filed its 2004 federal income tax return in 2005 and amended the return in 2008. The trust claimed a charitable deduction for the donated real property based on its fair market value. The trust reported that the aggregate adjusted basis in the donated real property was approximately $10.7 million and the properties' aggregate fair market value at the time of donation was $30.3 million. The IRS determined that the deduction for the real property contributed should be limited to the adjusted basis of the real property.

The Trustee filed this action alleging that the IRS "erroneously" concluded that the charitable deduction for the real property donated in 2004 was limited to the basis of the real property contributed, and thus, because of this error, the trust had overpaid income tax by more than $3 million and was entitled to a refund. The district court found in favor of the Trustee and awarded the trust $2,754,514, plus interest, in overpaid taxes.

On appeal, the Court of Appeals for the Tenth Circuit reversed the decision. In examining the authorized amount of a deduction under IRC § 642(c)(1), the Court of Appeals considered the parameters around the deduction; that an irrevocable trust may claim a charitable deduction for "any amount of the gross income" that, pursuant to the governing instrument, is paid for a charitable purpose. The Court of Appeals found that the phrase "any amount of the gross income" includes property purchased with gross income (such as the real property in this case) when such property is transferred for a charitable purpose.

However, the Court of Appeals sided with the IRS' construction of IRC § 642(c)(1) that the amount of the deduction must be limited to the adjusted basis of the property and not based on the fair market value of the donated property. The language of IRC § 642(c) is notably different than the language of IRC § 170, which applies to individuals and corporations, not trusts, and allows for deductions based on the fair market value of donated property. The Court of Appeals noted that if Congress had intended for the concept of "gross income" in this instance to extend to unrealized gains on property purchased with gross income, it would have said so. In addition, the Court of Appeals agreed with the IRS that allowing the deduction under IRC § 642(c)(1) to extend to unrealized gains "would be inconsistent with the Code's general treatment of gross income." Relying on IRC § 61(a) and its underlying regulations, the Court of Appeals stated that gross income does not include the appreciation in the value of real property until the taxpayer realizes the gain by selling or exchanging the property, which did not occur in this case.

B. IRS Proposes Guidance and Requests Comments Regarding the Application of Excise Taxes to Donor-Advised Funds

Notice 2017-73, 2017 I.R.B. 5621 (December 4, 2017)

The IRS and Treasury Department are considering proposed regulations related to donor-advised funds and their sponsoring organizations. If finalized, they would provide the following:

1. Certain distributions from a donor-advised fund that pay for the purchase of tickets that enable a donor or donor advisor (or certain related persons under IRC § 4958(f)(7)) to attend or participate in a charity-sponsored event would result in "more than incidental benefit" to the donor or donor advisor and thus give rise to an excise tax under IRC § 4967. The Notice provides that this transaction may also result in an excess benefit transaction under IRC § 4958.

2. Certain distributions from a donor-advised fund that the recipient charity treats as fulfilling a pledge made by a donor or donor advisor (or certain related persons) would not result in a more than incidental benefit under IRC § 4967, regardless of whether the recipient charity treats the distribution as satisfying the pledge and regardless of whether the pledge is enforceable under current law. The sponsoring organization must make no reference to the existence of any individual's pledge when making the distribution. Further, no donor or advisor may receive any other benefit that is more than incidental following the distribution. The donor or advisor must not attempt to claim a charitable contribution deduction under IRC § 170 with respect to the distribution. These rules would not apply for purposes of determining whether this transaction gives rise to excise taxes for self-dealing under IRC § 4941. The IRS specified that taxpayers could rely on these rules until additional guidance is issued.

3. Changes to the public support computation for publicly-supported charities described in IRC §§ 170(b)(1)(A)(vi), 509(a)(1) and 509(a)(2) to treat a sponsoring organization's distribution from a donor-advised fund as coming from the donor (or donors) that funded the donor-advised fund rather than from the sponsoring organization. The new rules would also require a donee organization to treat all anonymous contributions (including a donor-advised fund distribution for which the sponsoring organization fails to identify the donor that funded the donor-advised fund) as being made by one person. Lastly, distributions from a sponsoring organization can be treated as public support without limitation if the sponsoring organization specifies that the distribution is not from a donor-advised fund or states that no donor or donor advisor advised the distribution.

Treasury and the IRS requested comments regarding these issues and suggestions for future guidance with respect to donor-advised funds. The IRS has also requested guidance regarding whether a transfer of funds by a private foundation to a donor-advised fund should be treated as a "qualifying distribution" for purposes of IRC § 4942. Written comments on these issues had to be submitted by March 5, 2018.

C. IRS Rules That CRUTs Were Disqualified Because of Improper Administration

PLR 201714002 and PLR 201714003 (April 7, 2017)

It is important to note that when the administration of a charitable remainder trust fails to comply with the governing trust instrument, this could result in disqualification of the trust. In *Estate of Melvine B. Atkinson v. Commissioner,* 309 F.3d 1290 (11th Cir. 2002), the trust provided for annual annuity payments to the settlor of the charitable remainder annuity trust in the amount of $200,000 for her life. However, the annuity payments were never made to her. The settlor's estate attempted to claim a $3.9 million charitable deduction on the settlor's estate tax return, but the deduction was not permitted by the IRS. The United States Court of Appeals for the Eleventh Circuit found that, because the annuity payments were never made to the settlor, the trust failed to comply with the rules for charitable remainder annuity trusts throughout its existence and thus the deduction was disallowed.

Along similar lines, the IRS in two PLRs (201714002 and 201714003) ruled that an improperly administered charitable remainder unitrust (CRUT) did not to qualify as a charitable remainder trust. The taxpayer (who was the initial Co-Trustee and unitrust beneficiary) intended to establish a trust that qualified as a CRUT, in part, to avoid capital gains tax on the sale of low basis assets on any subsequent sale. The CRUT was supposed to make guaranteed percentage unitrust payments to the taxpayer each year, but, instead, the governing instrument provided for the lesser of the unitrust payments or net income payments to the taxpayer, with net income makeup provisions as well. The lawyers for the taxpayer also advised that funding the CRUT would not be a completed gift because the taxpayer would retain the right to change successor beneficiaries; however, they failed to include such a provision in the instrument. The taxpayer also funded the trust with additional assets based on the erroneous belief that the value of the trust property would be excluded from the taxpayer's estate (which it was not, due to his retained interest). The rulings state these were among the numerous "misleading and legally erroneous representations regarding the operation of the trust." Even though the intended purpose of the CRUT was to yield an annual fixed percentage payment to the taxpayer, the CRUT was never able to generate enough income to equal the fixed percentage amount. The Trustee increased the net income amount by including capital gains in the calculation – a decision that was contrary to applicable state law.

Upon the taxpayer's death, the successor unitrust recipient was made aware of the trust's flaws and filed an action to terminate the trust. The court ruled that the trust was void *ab initio*, subject to a favorable ruling by the IRS that the court's ruling would have no adverse federal tax consequences. However, the IRS ruled that it could not issue a ruling on any adverse federal tax consequences because such a ruling would be equivalent to a rescission, upon which the IRS cannot rule based on Rev. Proc. 2016-3, 2016-1 I.R.B. 126. It was ultimately determined that the trust was not void but, rather, was to be treated as a private foundation. As a result, it would be subject to private foundation excise taxes under IRC §§ 4941 and 4945. In order to avoid these excise taxes, the trust could voluntarily terminate its private foundation status pursuant to IRC § 507 but would then be subject to a termination tax.

D. Conditional Bargain Sale to Charity Did Not Qualify for Charitable Deduction

Fakiris v. Commissioner, T.C. Memo. 2017-126 (June 28, 2017)

1. <u>Facts</u>. Petitioner is a commercial real estate owner and developer, whose company ("Grou") purchased the St. George Theatre on Staten Island in 2001 for $700,000. Grou purchased the theater with the intention of developing it into a highrise structure, but encountered significant community opposition. Grou did minor patching to the roof of the structure, but no other repairs, before looking for a method to divest itself of the theater.

A third party organized a nonprofit corporation, Richmond Dance Ensemble ("RDE"), for the purpose of preservation, restoration and use for the public good of the theater, in addition to dance training and performance. RDE came to an agreement with Grou to transfer the theater as a bargain sale transaction, however, Grou was hesitant regarding the transaction due to RDE not yet having received recognition by the IRS as a tax-exempt charitable organization.

The organizer of RDE coordinated with WEMGO Charitable Trust, Inc. (WEMGO), a recognized tax-exempt charitable organization, to facilitate the transfer. The three parties agreed that Grou would transfer the theater to WEMGO for $470,000 paid by the organizer of RDE, and WEMGO would transfer the theater to RDE once it received its tax-exempt charitable status.

The Contract for Sale specified that WEMGO's deed would be restricted to only allow transfer for the first five years of ownership to RDE, which transfer might occur after receipt of tax-exempt charitable status.

The parties executed all the transfer documents on June 29, 2004, including the transfer to RDE. RDE received its tax-exempt charitable status on September 30, 2004, effective May 11, 2004. Prior to the transfer, Grou had the theater appraised "as is" and was told the estimated market value was $5 million.

Petitioner claimed a $3 million non-cash charitable deduction on his 2004 federal income tax return, with carryovers into 2005, 2006, 2007 and 2008. This $3 million amount reflects Petitioner's 60% ownership of Grou and the appraised value of the theater, without discounting for any portion of the sale price. The IRS issued a notice of deficiency for 2006, 2007 and 2008, disallowing the charitable contribution deduction.

2. <u>Analysis</u>. A taxpayer who sells property to a charity for less than the property's fair market value is generally entitled to a charitable contribution deduction equal to the difference. *See Stark v. Commissioner*, 86 T.C. 243 (1986); *Knott v. Commissioner*, 67 T.C. 681 (1977); *Waller v. Commissioner*, 39 T.C. 665 (1963). However, this contribution is only deductible if it constitutes a completed gift, meaning that the donor must part with all incidences of ownership. *Coffey v. Commissioner*, 141 F.2d 204 (5th Cir. 1944), *aff'g* 1 T.C. 579 (1943). The IRS argued in this matter that Grou's transfer of the theater was not a completed gift because it retained the ability to direct transfer of the theater to RDE. The court agreed, stating that the documents show an intent that the limitation allowing transfer only to RDE survive closing and continue for up to 5 years. Even though the transfer happened the same day, had the transfer not occurred, equity would allow Grou and RDE to reform the deed and enforce the provision. *See Harris v. Uhlendorf*, 248 N.E.2d 892 (N.Y. 1969); *Beebe v. La Pierre*, 494 N.Y.S.2d 225 (App. Div. 1985). The retained right to direct the sale of the theater meant that Grou did not have a completed charitable gift to report, and Petitioner therefore could not use the charitable contribution as a deduction on his returns.

Moreover, the court found that the IRS was correct in applying penalties because the Supreme Court has rejected any distinction between valuation misstatements resulting from legal errors versus valuation errors. *See Woods v. United States*, 134 S. Ct. 557 (2013). Where the correct value of property reported as a charitable contribution is zero and the value claimed is greater than zero, the gross valuation misstatement penalty applies. IRC § 6662(h).

VIII. Asset Protection: State Statute Cannot Limit Jurisdiction of Other States or of Federal Bankruptcy Court

Toni 1 Trust v. Wacker, 413 P.3d 1139 (Alaska March 2, 2018)

A. Facts

A Montana state court entered a series of judgments against the Tangwell family, after which the Tangwell family transferred two pieces of property to the "Toni 1 Trust" (the "Trust"), which for purposes of this action, the court treated as an Alaskan trust. A Montana state court and an Alaska bankruptcy court each found that the transfers were made to avoid the judgments against the Tangwell family and were therefore fraudulent. The Trustee of the Trust filed suit, arguing that Alaska state courts have exclusive jurisdiction over fraudulent transfer actions under Alaska Statute 34.40.110(k), and requesting the judgments of the other courts be declared void for lack of subject matter jurisdiction.

B. Analysis

Alaska law provides for self-settled spendthrift trusts, under Alaska Statute 24.40.110. Subsection (b)(1) of that statute creates a limited cause of action for fraudulent transfers: a creditor of the settlor of the trust can reach trust property if the creditor can prove that the settlor's transfer of the property to the trust was made with the "intent to defraud that creditor." This is the only cause of action by which a litigant can reach property in an Alaska self-settled spendthrift trust, and the statute provides that Alaska courts have "exclusive jurisdiction over an action brought under a cause of action or claim for relief that is based on a transfer of property to a [self-settled spendthrift] trust." Alaska Statutes 24.40.110(k)

The Trustee argued, and the legislative history showed, that this provision is meant to prevent other state and federal courts from exercising subject matter jurisdiction over fraudulent transfer actions against Alaskan self-settled spendthrift trusts. However, the court held that a statute could not circumscribe other courts' jurisdiction in such a manner, citing to *Tenn. Coal, Iron, & R.R. Co. v. George*, 833 U.S. 354 (1914), which stated that the Full Faith and Credit Clause does not compel states to follow another state's statute claiming exclusive jurisdiction even though the other state created the right of action. The court specifically noted that while comity suggests that limitations one state's legislature places on its own laws would be universally acknowledged, comity is not a legal rule, and courts are not compelled to apply it. *See Marine Midland Bank v. United Mo. Bank*, 643 N.Y.S.2d 528 (N.Y. App. Div. 1996) ("Comity does not require or suggest that the courts of this State should surrender their interest in adjudicating disputes…").

The court additionally held that a state cannot restrict federal courts' jurisdiction even though the state created the right of action. *Marshall v. Marshall*, 547 U.S. 293 (2006) (*quoting Tennessee Coal*). Specifically, if the statute at issue were interpreted to deny parties access to the federal courts without those courts' consent, the statute "might well run afoul of the Supremacy Clause." *Allstate Ins. Co. v. Gammon*, 838 F.2d 73 (3d Cir. 1988).

IX. Lawyer Liability

A. Beneficiaries In An Unexecuted Trust Instrument Did Not Have Standing To Bring Suit Against the Drafting Lawyer

Estate of Agnew v. Ross, 152 A.3d 247 (Pa. January 19, 2017)

1. <u>Facts.</u> In November 2003, Robert Agnew ("Mr. Agnew") retained Daniel Ross ("Mr. Ross") to prepare a Will and an amendment to his revocable trust. Mr. Ross prepared several amendments to the Will and trust in the past. In March 2010, Mr. Agnew was admitted to hospice. Margaret Alzamora ("Ms. Alzamora") contacted Mr. Ross on behalf of Mr. Agnew to make additional changes to his estate planning documents, including limiting the amounts that were going to charity to provide more funds to Ms. Alzamora and other appellees. Several months later, Ms. Alzamora again contacted Mr. Ross and advised him that the residue of Mr. Agnew's trust was no longer to be distributed to three colleges, but rather divided into five equal shares for Ms. Alzamora and four other appellees. She also informed Mr. Ross that Mr. Agnew wished to make additional gifts to the children of appellees. Mr. Ross then prepared the appropriate amendments to the trust instrument and Will. In September 2010, Mr. Agnew signed the 2010 Will, but did not sign the 2010 trust amendment. Mr. Agnew died in January 2011. Letters Testamentary were granted to Ms. Alzamora and the Will was admitted to probate. One month later, Mr. Ross informed Ms. Alzamora that he believed the 2010 trust amendment was never executed. Ms. Alzamora, along with the other appellees and Mr. Agnew's estate, filed suit against Mr. Ross, his partner and his law firm, alleging malpractice and breach of the contract to provide legal services to Mr. Agnew when Mr. Ross failed to have Mr. Agnew sign the 2010 trust amendment. Ms. Alzamora and the appellees claimed to be third party intended beneficiaries of the contract for legal services, and as a result of the breach, they were denied sums of money they were entitled to under the 2010 trust amendment.

During discovery, Mr. Ross stated that Mr. Agnew was aware of the 2010 trust amendment and that he had previously reviewed it, but it was mistakenly not one of the documents that Mr. Ross signed at the September 2010 meeting. Once discovery closed, the court granted summary judgment in favor of the appellant. The court held that in order to maintain the breach of contract claim, appellees needed to show that there was an "otherwise valid" document naming them as recipients of all or part of the estate. The court also stated that there was "no competent evidence of that which transpired at the September [2010] meeting between Mr. Agnew and Ross." On appeal, the Superior Court reversed, finding that there was evidence of the September 2010 meeting and that the trial court did not examine the facts in the light most favorable to the appellees. The case was taken up on further appeal.

2. <u>Analysis.</u> Appellants first argued that the Superior Court's decision to allow the appellee's lawsuit conflicts with the narrow exception to strict privity in *Guy v. Liederbach*, 459 A.2d 744 (Pa. 1983). Appellants stated that in *Guy*, the court examined the provisions of an executed Will to determine the testator's intent regarding intended third-party beneficiaries of a contract between the testator and his lawyer. Appellants argued that to allow an action for malpractice against a testator's lawyer in the absence of an executed testamentary document identifying that party as a beneficiary would undermine the integrity of properly executed wills and enhance the risk of misinterpretation of the testator's intent. Appellants further argued that a testator's lawyer owed no obligation to potential heirs to have testamentary documents executed. This court agreed and ultimately held that "an executed testamentary document naming an individual as a legatee is a prerequisite to that individual's ability to enforce the contract between the testator and the attorney he hired to draft that particular testamentary document." Here, the appellees were beneficiaries of an unexecuted trust amendment, so they did not have standing to recover on a contract claim against appellants. The court further held that an unexecuted testamentary document could not be relied upon due to the policy consideration against using extrinsic evidence to speculate about a testator's intent. The court also noted that the Superior Court's reliance on a footnote in *Guy*, stating that non-named beneficiaries had standing to sue the drafting attorneys, did not apply to the facts in this case. The court concluded that those "non-named beneficiaries" referred to people who were generally identified, as opposed to being identified by name, because they were people or entities to be identified after the testator's death (such as "my children" or "my heirs"). That was not the case here.

B. Bank Has No Standing as Personal Representative or Trustee in Claim for Legal Malpractice

Security Bank & Trust Co. v. Larkin, 2018 Minn. LEXIS 338 (June 27, 2018)

1. **Facts.** The Respondent law firm, Larkin, Hoffman, Daly & Lindgren, Ltd. ("Larkin") drafted a Will and revocable trust agreement for Gordon P. Savoie ("Savoie") in 2009. Following a number of specific bequests, the trust agreement directed that 45% of the remaining trust assets be distributed to a beneficiary who was more than 37.5 years younger than Savoie, and thus was subject to a ("GST") tax totaling approximately $1.654 million.

Following Savoie's death, Security Bank was appointed Trustee and Personal Representative of his estate. Security Bank subsequently filed suit against Larkin, alleging that Larkin never advised Savoie of the GST tax associated with the bequest, and never discussed options for reducing the tax. Larkin moved for summary judgment on the pleadings due to a lack of standing of a Personal Representative to bring a legal malpractice action, because such action did not accrue during Savoie's lifetime. Additionally, Larkin argued that Security Bank lacked standing as Trustee of Savoie's revocable trust because Larkin had no attorney-client relationship with Security Bank.

The District Court granted Larkin's motion, after applying the "some damage" rule outlined in *Antone v. Mirviss*, 720 N.W.2d 331 (Minn. 2006). The court found that "some damage" did not occur until after Savoie's death when the GST tax came due, and because no cause of action accrued during Savoie's lifetime, no cause of action survived to Security Bank as Personal Representative. Moreover, Security Bank did not have standing as Trustee because there was no attorney-client relationship with Larkin and Security Bank was not a direct or intended beneficiary of Larkin's relationship with Savoie.

The court of appeals reversed. The court opined that "some damage" occurred during Savoie's lifetime, because of his "reliance" to his detriment on his attorney's allegedly negligent advice at the time that he executed his Will and trust agreement. Thus, Security Bank did have standing to file suit as Personal Representative. Because the court of appeals determined that Security Bank had standing as Personal Representative, it did not address whether the bank had standing as Trustee. The Supreme Court of Minnesota granted further review and ultimately found no standing for Security Bank, and reversed the court of appeals.

2. **Analysis.** The Supreme Court of Minnesota considered whether a claim for legal malpractice must accrue during the client's lifetime (giving the Personal Representative standing under Minn. Stat. § 524.3-703) or whether a Personal Representative may pursue a claim for legal malpractice that did not accrue until after the decedent's death. The statute states that a Personal Representative has the same standing to sue as the decedent had immediately prior to death. In this context, the court relied on the same "some damage" of accrual considered by the lower courts. After assessing past precedent, the Supreme Court of Minnesota found that "some damage" must involve concrete harm of either a financial liability or a loss of a legal right. In the present case, no concrete harm as a result of Larkin's allegedly negligent advice

occurred until after Savoie's death when the estate became liable for the GST tax. Security Bank did not allege any material injury or harm from Savoie's reliance on Larkin's advice. Thus, no cause of action for malpractice survived to Security Bank because one did not accrue during Savoie's lifetime.

The Supreme Court of Minnesota further outlined that for an attorney to be liable for professional negligence, there must be an attorney-client relationship. If there is no relationship, one must satisfy one of the exceptions to this rule requiring privity. One such limited exception relevant to this case is when a non-client third party is a "direct and intended beneficiary" of the lawyer's services. A third party is a "direct beneficiary of a transaction if the transaction has[,] as a central purpose[,] an effect on the third party and the effect is intended as a purpose of the transaction," *citing McIntosh County Bank v. Dorsey & Whitney*, LLP, 745 N.W.2d 538 (Minn. 2008). The court reasoned that, in the trust context, the trust beneficiaries are the direct and intended beneficiaries of the lawyer's legal services, not the trust instruments themselves. Trusts cannot be direct and intended beneficiaries, so a Trustee would not fit under this exception. Moreover, there is no evidence to establish that Savoie had any intent to benefit Security Bank. Thus, Security Bank failed to satisfy the third-party exception to the privity requirement, and cannot state a claim for malpractice in its capacity as Trustee.

X. Supreme Court Holds That State Statute Revoking Beneficiary Designation Upon Divorce Does Not Violate Contracts Clause

Sveen v. Melin, 138 S. Ct. 1815 (June 11, 2018)

In 2002, the Minnesota legislature enacted a statute providing that "the dissolution or annulment of a marriage revokes any revocable beneficiary designation…made by an individual to the individual's former spouse." Minn. Stat. § 524.2-804, subd. 1 (2016). Under this default rule, if one spouse has made the other the beneficiary of a life insurance policy or similar asset, their divorce automatically revokes that designation so that the insurance proceeds will instead go to a contingent beneficiary or the policy holder's estate on death.

Mark Sveen ("Sveen") married the respondent Kaye Melin ("Melin") in 1997. The following year, Sveen purchased a life insurance policy and named Melin as the primary beneficiary. His two children from a prior marriage, Ashley and Antone, were named contingent beneficiaries. Sveen and Melin divorced in 2007, and their divorce decree made no mention of the life insurance policy, nor did Sveen revise the beneficiary designation. Sveen died in 2011 and his children and Melin made competing claims to the insurance proceeds. From the children's standpoint, Minnesota's revocation-on-divorce law made them the rightful recipients of the proceeds. Melin argued that the law was not in place at the time the policy was purchased, and to apply the later-enacted law would violate the Constitution's Contracts Clause. The District Court sided with the Sveen children, and the Eighth Circuit reversed after finding that retroactive application of the Minnesota statute violated the Contracts Clause.

The United States Supreme Court granted certiorari to resolve a split of authority over whether the Contracts Clause prevented a revocation-on-divorce law from applying to a pre-existing beneficiary designation. The Court found that applying Minnesota's revocation-on-divorce statute to a beneficiary designation made before the statute's enactment did not violate the Contract's Clause.

In making its findings, the Supreme Court considered whether the Minnesota state law undermined the contractual bargain, interfered with a party's reasonable expectations and prevented the party from safeguarding or reinstating his or her rights. The Court held that, by revoking a beneficiary designation after divorce, the effect of the statute was consistent with the contracting party's expectation and intention – that Sveen would not want the policy proceeds to be awarded to his ex-spouse (and, if that was his intended result, he could simply rename the ex-spouse in a new beneficiary designation form post-divorce). The Minnesota state law was only a default rule that can be overridden by the contacting party. The Court notes that the legal system has long used default rules to resolve estate litigation questions to conform to a decedent's presumed intent.

XI. Retirement Assets

A. Purported Beneficiary's Claim to Retirement Assets Denied Because Beneficiary Designation Did Not Comply with Plan Documents

Ruiz v. Publix Super Markets, 248 F. Supp. 3d 1294 (M.D. Fla. March 30, 2017)

1. <u>Background</u>. Decedent was a former employee of Publix Super Markets, Inc. ("Publix"). During her employment, Decedent participated in the Publix Super Markets, Inc. Employee Stock Ownership Plan and the Publix Super Markets, Inc. 401(k) SMART Plan (together, "the Plans"). The Summary Plan Descriptions for the Plans provided for an initial beneficiary designation and directions for changing the designated beneficiary via a "Beneficiary Designation Card." In October of 2008, Decedent named her nephew, Alexander Perez-Vargas, and two nieces, Andrea Vargas and Jessica Vargas, as beneficiaries of the Plans.

In January 2015, Decedent called Publix to determine the procedure for changing the beneficiaries. The Publix representative instructed Decedent to write a letter naming the updated beneficiary, along with social security numbers if available, and to sign and date such letter. The Publix representative explained that completion of the "Beneficiary Designation Card" was not required. Decedent thereafter sent a letter attempting to change the beneficiary of the Plans to Arlene Ruiz, with whom Decedent had been in a long-term, committed relationship, and enclosed "Beneficiary Designation Cards." On the signature lines of the "Beneficiary Designation Cards," Decedent wrote "as stated in letter" rather than signing.

Upon Decedent's death, Ruiz made a claim for benefits under the Plans. Publix denied her claim, explaining that she was not the designated beneficiary of the Plans. Because Publix had not received properly designated beneficiary cards listing Ruiz as the beneficiary, there was no change to the designated beneficiaries for both plans.

2. <u>Strict Compliance Versus Substantial Compliance</u>. The Court held that the employer's decision to deny the purported beneficiary's claim to proceeds of the Plans was not wrong, noting that even if Decedent intended to change the beneficiary of the Plans and attempted to do so, she did not strictly comply with the Plans' directives for changing the beneficiary.

The court would not consider the equitable doctrine of substantial compliance because such doctrine's viability was doubtful given recent court decisions such as *Kennedy v. Plan*

Administrator for DuPont Savings and Investment Plan, 555 U.S. 285 (2009), in which the United States Supreme Court emphasized the duty of a plan administrator to act in accordance with the plan documents. In *Kennedy*, the Supreme Court specifically stated that ERISA forecloses any justification for inquiries into expressions of intent that do not comply with the plan documents.

B. Court Finds Probate Exception Applies to Federal Question Jurisdiction
In re Boisseau, 2018 U.S. Dist. LEXIS 11964 (N.D.N.Y. January 30, 2017)

Edward Boisseau ("Mr. Boisseau") died on October 15, 2014. Mr. Boisseau's wife, Brenda Boisseau ("Ms. Boisseau") served as Executor of his estate. Prior to his death, Mr. Boisseau received medical treatment for prostate cancer and certain medical expenses, totaling $299,975.73, which were paid out of an employee benefit plan (the "Plan") under the Employee Retirement Income Security Act ("ERISA").

Ms. Boisseau brought a personal injury action against Mr. Boisseau's medical providers for medical malpractice and wrongful death arising out of medical negligence with respect to Mr. Boisseau's treatment in 2012. A settlement agreement was reached in the action, and shortly thereafter, the Plan, through a collection agency, asserted a lien against the settlement proceeds seeking repayment of funds expended to cover Mr. Boisseau's medical treatment. Ms. Boisseau requested information from the Plan regarding the validity of the lien but received no response. She eventually sought to vacate the lien in the Oswego Surrogate's Court. The court then issued an order to show cause as to why the lien should not be dismissed. The Plan then sought to remove the action to United States District Court for the Northern District of New York by asserting federal question jurisdiction under ERISA, which permits a defendant to remove any civil action brought in State court to a district court of the United States. 28 U.S.C. § 1441(a). However, federal courts may not hear cases where there is no subject matter jurisdiction. Before reaching any conclusions on the issue of subject matter jurisdiction, the court addressed a separate basis for remand in this case, which is the probate exception to federal jurisdiction. The court noted that while it is clear the exception applies to diversity jurisdiction, there is some question as to its applicability to federal question jurisdiction.

The Second Circuit has not ruled on this issue, but the court considered other courts that have, and also considered the policy considerations involved. The Ninth Circuit has noted that "the evil to be avoided is federal interference with state probate proceedings." *In re Marshall*, 392 F.3d 1118 (9^{th} Cir. 2004). The Seventh Circuit has similarly noted that the reasons for keeping federal courts out of the business of probating wills are as persuasive when the suit is filed in federal court on the basis of federal law as when it is based on state law. *Jones v. Brennan*, 465 F.3d 304 (7^{th} Cir. 2006). This court agreed and found that the probate exception applies to cases arising out of both federal question and diversity jurisdiction. As such, the court saw no reason why it should not apply to cases involving ERISA. This court further noted that "the res of Mr. Boisseau is subject exclusively to the jurisdiction of the Oswego County Surrogate's Court," and any claim against the settlement proceeds is a claim against his estate. Therefore, the probate exception required remand of the action to the Surrogate's Court.

XII. Ethics: Lawyer Had No Duty to Disclose to Trust Beneficiaries That Trustee Converted Trust Assets

NY State Bar Association, Committee on Professional Ethics Opinion 1126 (June 19, 2017)

Lawyer prepared a joint revocable trust for Husband and Wife. The trust instrument provided that, upon Wife's death, her share of the trust assets would be distributed to credit shelter trust for the benefit of Husband. Upon Husband's death, the assets in the credit shelter trust would be distributed to Wife's children from a prior marriage.

Wife predeceased Husband. Husband then met with Lawyer to discuss trust administration. Husband then declined to proceed with Lawyer.

Husband then died. Husband's sister ("Sister") was designated to act as the successor Trustee. Sister contacted Lawyer. Sister then disclosed to Lawyer that Husband did not fund the credit shelter trust. Instead, Husband transferred the assets to himself and for the benefit of Sister. Thus, Wife's children's beneficial interests in the trust property was eliminated. Lawyer told Sister that Lawyer cannot represent her in the administration of the trust.

The New York Committee on Professional Ethics addressed the question of whether Lawyer is authorized or required to advise Wife's children that the credit shelter trust assets were diverted. The Committee explained that Sister was a prospective client under Rule 1.18(a) of the New York Rules of Professional Conduct (the "Rules"), which defines a prospective client as "a person who consults with a lawyer about the possibility of forming a client-lawyer relationship with respect to a matter." The Committee found that Sister had a reasonable expectation that Lawyer was willing to discuss the possibility of forming a client-lawyer relationship.

Lawyer therefore owed a duty of confidentiality to Sister. Rule 1.18(b). Lawyer could not disclose information unless: (1) Sister gave informed consent in writing or (2) the disclosure was permitted by Rule 1.6(b). The Committee stated that neither exception applied here.

The Committee stated that the information received from Sister was confidential because disclosure of the information would be damaging to Sister. Sister did not give informed consent to disclosure to Wife's children. Disclosure was not impliedly authorized under Rule 1.6. None of the other exceptions under Rule 1.6(b) applied.

Thus, the Committee found that disclosure was not permitted. The Committee added that this information also may be confidential information subject to the duties that Lawyer owes to Husband as a former client. Rule 1.9.

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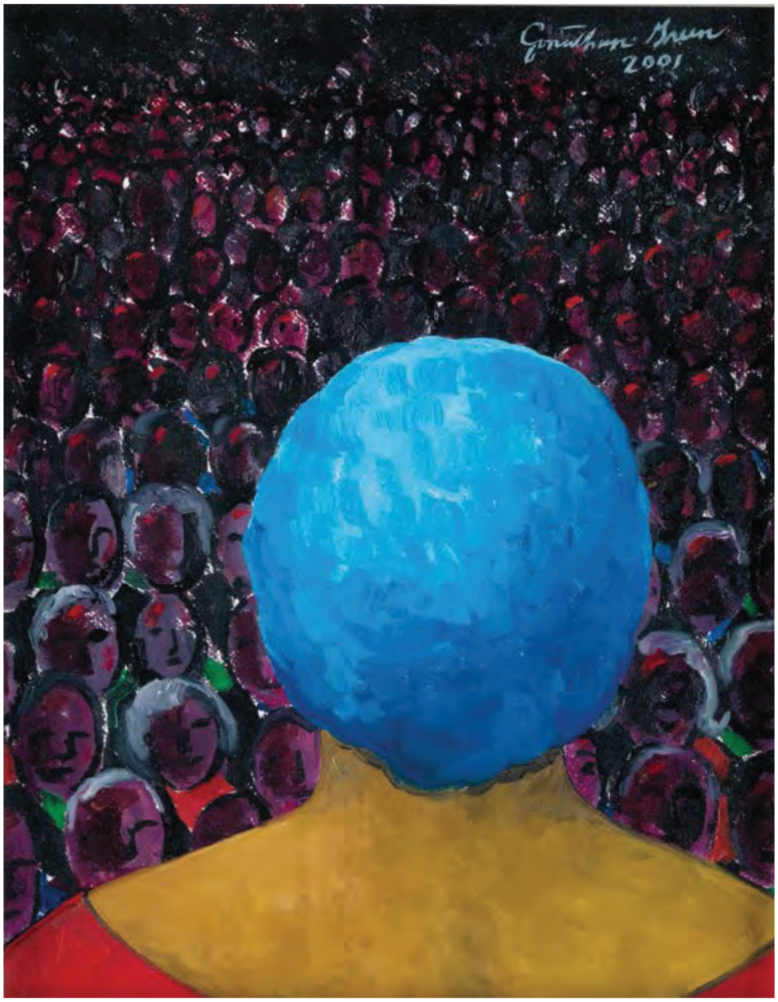

Encore—"The Performance" (10 in. by 8 in.) by Jonathan Green, sold for $2,000 at Swann Auction Galleries' African-American Fine Art sale in New York City on Oct. 6, 2016, p. 4.

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that can help fulfill philanthropic desires while transferring assets to the next generation and reducing or eliminating transfer taxes.

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Endnotes

1. *See www.irs.gov/uac/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income#_grp5.*
2. *Ibid.*
3. *Ibid.*

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TIPS FROM THE PROS

When Actions Speak Louder Than Words

By Charles A. Redd, a partner at Stinson Leonard Street LLP in St. Louis and a Fellow of The American College of Trust and Estate Counsel

Cases decided over the past several years have demonstrated that defective trust administration, whether negligent or intentional, can cause a tax disaster even if the underlying trust instrument is technically sound.

CRAT Regs Not Followed

In *Estate of Atkinson*,[1] Melvine Atkinson created a charitable remainder annuity trust (CRAT) funded with stock worth about $4 million. Under the CRAT's governing instrument, Melvine was to receive an annual annuity of $200,000 for her life. The trust instrument provided for annuity payments to be made to successor beneficiaries following Melvine's death if they agreed to pay their share of any estate taxes due at her death. After the death of the last annuity amount beneficiary, all remaining trust property was to be distributed to charity. Melvine died, and her estate claimed a charitable estate tax deduction in an amount equal to the present value of the charitable remainder interest in the CRAT as of Melvine's date of death.

There was just one problem. It turned out that, although there was no ambiguity or defect whatsoever in the trust instrument, no annuity payments had ever actually been made to Melvine. Accordingly, the Internal Revenue Service, on audit of Melvine's estate tax return, disallowed the charitable deduction for the CRAT remainder because the CRAT had failed to operate in accordance with Internal Revenue Code Section 664, the applicable Treasury regulations and the requirements of the trust instrument. The estate argued that the IRS, by focusing stringently on the CRAT rules, would deny a substantial charitable deduction because of a "foot fault" or a minor mistake, ignoring the certainty that CRAT property worth millions of dollars would pass to charity as a result of Melvine's death.

The U.S. Court of Appeals for the Eleventh Circuit sided with the IRS. The court concluded the CRAT didn't give rise to an estate tax charitable deduction under IRC Section 2055 because "the CRAT regulations were not scrupulously followed."[2] The court said:

> It is not sufficient to establish a trust under the CRAT rules, then completely ignore the rules during the trust's administration … Despite the certain charitable donation in this case, the countervailing Congressional concerns surrounding the deductibility of charitable remainders in general counsel strict adherence to the Code, and, barring such adherence, mandate a complete denial of the charitable deduction.[3]

Actions Created Grantor Trust

In *Securities and Exchange Commission v. Wyly*,[4] Sam and Charles Wyly created and funded 17 offshore trusts and designated professional asset managers in the Isle of Man as trustees. The beneficiaries, in a variety of combinations among the trusts, included Sam and Charles, their spouses, their children and charitable organizations. Each trust had three trust protectors: Sam and Charles' lawyer, the chief financial officer (CFO) of the Wylys' family office and the CFO of a Wyly-related offshore entity. Neither any of the trustees

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nor any of the trust protectors was a "related or subordinate party" within the meaning of IRC Section 672(c). Among the trust protectors' powers were to "add[] or substitut[e]" a charitable organization as a beneficiary and to remove and replace the trustees.

In making investments (including in Wyly family businesses and a fund run by Sam's son-in-law), and in purchasing lavish personal use items accessed and enjoyed by the trust beneficiaries, the trustees always followed the directions of the trust protectors, who received their marching orders from Sam and Charles.

The trusts were designed to be non-grantor trusts for federal income tax purposes. The trusts' governing instruments were properly drafted to accomplish this purpose. Because these were foreign, non-grantor trusts, none of the income generated by and retained in the trusts would be subject to U.S. income tax. At least that's what Sam and Charles thought.

The court first observed that the trustees had powers of disposition in respect of beneficial enjoyment potentially giving rise to grantor trust treatment under IRC Section 674(a) but then said the trustees were ostensibly independent within the meaning of Section 674(c). The court concluded, however, that the Section 674(c) independent trustee exception (which, if it applied, would have rendered Section 674(a) inapplicable) didn't apply because the trustees' powers of disposition weren't solely exercisable by them. Taking note of the facts that: (1) the trustees invariably followed the directions of the trust protectors; (2) in giving directions to the trustees, the trust protectors invariably followed the instructions of Sam and Charles; (3) the trust protectors were explicitly empowered to remove and replace the trustees; and (4) Sam and Charles had close relationships with the trust protectors, the court reached this conclusion notwithstanding that Sam and Charles had no legal right to control the trust protectors.

The court acknowledged but rejected as "rigid" and "unwarranted" the Wylys' construction of the holding of a very analogous case, *Goodwyn*,[5] in which the Tax Court stated a grantor may be subject to tax under Section 674(a) only on "a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent Trustee who is receptive to his wishes."[6]

In the end, the court had no difficulty concluding that economic realities, rather than the literal terms of the underlying trust instruments, should control the income tax status of the trusts. The court was convinced Sam and Charles, as trust settlors, effectively controlled the actions of the trustees. The result was that, since the Section 674(c) independent trustee exception didn't apply, the trusts were treated as grantor trusts, a disastrous result that ultimately forced the Wyly brothers into bankruptcy.

Deduction Limited

In Estate of Dieringer,[7] Victoria Dieringer died in 2009 and left her personal effects to her children, made $600,000 in pecuniary gifts and left all the rest of her estate and trust (revocable until her death) to the Bob and Evelyn Dieringer Family Foundation (Foundation). Victoria's son, Eugene, was sole executor of her will, sole trustee of her trust and sole trustee of the Foundation.

Most of Victoria's assets consisted of a majority interest in Dieringer Properties, Inc. (DPI), a closely held business that managed commercial and residential real estate. Eugene was president, a director and a shareholder of DPI. Victoria's trust owned 425 of 525 voting shares and 7,736.5 of 9,220.5 non-voting shares of DPI at the time of her death. The federal estate tax return for Victoria's estate (Form 706) reflected that her equity in DPI at her death had a fair market value of $14,182,471. Each voting share had an estate tax value of $1,824, and each non-voting share had an estate tax value of $1,733 per share. Victoria's DPI stock was valued on a majority interest basis. The estate reported no estate tax liability.

In connection with a redemption of the trust's DPI stock, Eugene inexplicably arranged for an appraisal of the trust's DPI shares on a minority interest basis. The appraiser, simply following Eugene's directions, applied various discounts and determined that the redemption price should be $916 per voting share and $870 per non-voting share. After the redemption (and implementation of the terms of a separate subscription agreement), Eugene owned 70 percent of DPI's voting stock and 48.6 percent of its non-voting stock. The Foundation received from Victoria's trust only 2,163 non-voting shares of DPI, a short-term note receivable in the amount of $2.25 million and a long-term note receivable in the amount of $2,921,312.

On audit of the Form 706, the IRS reduced the estate's charitable deduction to the amount equal to the value of property actually distributed to the Foundation. In holding for the Commissioner, the Tax Court found that the Foundation didn't receive the DPI shares (or their value following the redemption) to which it was entitled under the governing instrument of Victoria's trust (the trust instrument). The Tax Court determined that the charitable deduction was limited to the amount actually transferred to the Foundation, rather than the amount to which the Foundation was entitled under the trust instrument and claimed as a charitable deduction on the Form 706. The Tax Court stated that:

> [i]f a trustee has the power to divert property to be transferred for charitable purposes 'to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent'…the charitable contribution deduction is limited to the portion, if any, of the property that is exempt from the trustee's exercise of the power.[8]

Similar Results Possible

Atkinson involved what was apparently an innocent mistake but seems like a roadmap for courts to reach similar results in circumstances involving unassailable trust instruments coupled with maladministration. A grantor-retained annuity trust (GRAT) could be considered not to qualify as such under IRC Section 2702 only because a GRAT payment wasn't made (or even if it was made but not timely). A qualified terminable interest property trust could be held not to qualify for the marital deduction under IRC Section 2056(b)(7) for no reason other than that, in a given year, an amount less than the entire net income was distributed to the surviving spouse/beneficiary. The value of assets in a non-marital trust, intended to be excluded from the surviving spouse/beneficiary's gross estate, could be included in the gross estate under IRC Section 2041 if the surviving spouse/beneficiary, as trustee, made a principal distribution to himself for a purpose broader than health, education, maintenance and support.

Wyly and *Dieringer* show the lengths to which a court may go to reach the "right" result in a case with egregious facts. In *Wyly*, the court ignored *Goodwyn*, 40-year-old contrary precedent that most knowledgeable observers thought was settled law. The *Dieringer* court sought to buttress its conclusion by referencing "a trustee [who] has the power to divert property to be transferred for charitable purposes,"[9] but the trustee in *Dieringer* had no such power at all. The *Dieringer* trustee grossly breached his fiduciary duties to the Foundation, and the Foundation inexcusably sat on its hands and accepted from Victoria's trust far less than that to which it was entitled.

Endnotes

1. *Estate of Atkinson v. Commissioner*, 309 F.3d 1290 (11th Cir. 2002).
2. *Ibid.*, at p. 1295.
3. *Ibid.*, at p. 1296.
4. *Securities and Exchange Commission v. Wyly*, 56 F. Supp.3d 394 (S.D.N.Y. 2014).
5. *Estate of Goodwyn v. Comm'r*, T.C. Memo. 1976-238.
6. *See supra* note 4, at p. 428.
7. *Estate of Victoria E. Dieringer v. Comm'r*, 146 T.C. No. 8 (March 30, 2016).
8. *Citing to* Treasury Regulations Section 20.2055-2(b)(1).
9. *Dieringer*, *supra* note 7, at p. 20.

SPOT LIGHT

Face to the Wind

"Daughters of the South," by Jonathan Green, sold for $2,750 at Swann Auction Galleries' African-American Fine Art sale in New York City on Oct. 6, 2016. Another interesting fact about Green, our cover star, is that he didn't have enough experience in the arts to enroll as an artist in the Art Institute of Chicago, so he entered as a fashion design student.

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Designing & Administering Trust Distribution Mechanisms

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Designing & Administering Trust Distribution Mechanisms

By: Charles A. Redd
Stinson Leonard Street LLP
St. Louis, Missouri

A. DISCRETIONARY DISTRIBUTION SCHEMES HAVING BROAD STANDARDS AND NARROW STANDARDS

1. Absolute Discretion

Wholly discretionary trusts are trusts in which distributions to the beneficiary are left solely within the discretion of an independent Trustee and usually without regard to an ascertainable or a definite standard. Generally, the governing instrument of a discretionary trust is drafted with permissive language, *e.g.*, the Trustee "may" (as opposed to "shall") make distributions. *See*, *e.g.*, *State ex rel. Secretary of Social and Rehabilitative Services v. Jackson*, 822 P.2d 1033 (Kan. 1991). A trust instrument that employs a totally discretionary distribution scheme ordinarily leaves the determination of distributions entirely to an independent Trustee to avoid creating an enforceable right in a beneficiary to receive anything from the trust.

The lack of standards or guidelines for the determination of when and how much will be distributed to the beneficiaries makes wholly discretionary trusts the most flexible for dealing with future family circumstances. The absence of standards and guidelines also helps to insulate (but by no means exonerate) the Trustee from lawsuits by beneficiaries considering a challenge to the Trustee's exercise of discretion in making (or failing to make) distributions.

The RESTATEMENT (SECOND) OF TRUSTS ("Restatement 2d") § 187 provides that, "[w]here discretion is conferred upon the Trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an abuse by the Trustee of his discretion." To determine whether a Trustee is liable for abuse of discretion, a court may consider: (a) the extent of the discretion conferred upon the Trustee by the terms of the trust; (b) the purposes of the trust; (c) the nature of the power; (d) the motives of the Trustee in exercising or refraining from exercising the power; and (e) the existence or nonexistence of an interest in the Trustee conflicting with that of the beneficiaries. Restatement 2d § 187, cmt. d. The Restatement 2d adds that a Trustee has abused its discretion if the Trustee acts dishonestly, with an improper motive or arbitrarily. Restatement 2d § 187, cmt. e, f.

2. Ascertainable Standards

Alternatively, a trust instrument may provide for one or more levels of entitlement by beneficiaries to distributions such as the right periodically to receive all of the trust's net income, an percentage unitrust amount or distributions of income and/or principal based on an ascertainable standard. The settlor can give the Trustee the power to make distributions in accordance with so-called "ascertainable standards," such as, "for the beneficiary's support, maintenance and education," "in the event of sickness, accident, misfortune or other emergency," etc. These provisions give the beneficiary an indication of what distribution amounts may reasonably be expected, as well as what additional financial support might be available. Ascertainable standard-based distribution schemes reduce flexibility, making it more difficult for the Trustee to deal with changed circumstances than would be the case with a wholly discretionary trust.

a. Consideration of Other Resources. When implementing such standards, a Trustee may be permitted or required by the governing instrument to look beyond the trust assets to determine whether a distribution should be made. For cases in which the trust instrument does not so provide, RESTATEMENT (THIRD) OF TRUSTS ("Restatement 3d") § 50, cmt. e, states that the "general rule of construction" presumes that the Trustee is to consider other resources but has some discretion in the matter. This Comment also provides that the Trustee should normally only take into consideration the beneficiary's income and "other periodic receipts."

The trust instrument should address whether other resources of the beneficiary should or may be taken into account and specify what resources should or may be considered. For example, the use of the phrase "other income" should permit or require the Trustee to take into account only other active sources of income. Language such as "other sources of income" implies that the Trustee should or may require that a beneficiary's own unproductive income sources be made productive. The use of a phrase such as "other assets or funds" implies that the beneficiary must liquidate all assets and use up the liquidation proceeds in order to receive distributions from the trust.

In *Hart v. Connors*, 228 N.E.2d 273 (Ill.App. 1967), the trust instrument stated that "my said wife may use all or any part of the corpus of the trust if required for her support or maintenance in accordance with her present standard of living." Although the court held that the wife's other income had to be considered in making principal distributions, the court went on to say: "[n]othing is said by the testator that she must first exhaust her own resources and we are not persuaded that she must do so."

In *O'Riley v. U.S. Bank, N.A.*, 412 S.W.3d 400 (Mo.App. W.D. 2013), a trust was created upon the death of Donald O'Riley in 1982. The governing instrument provided that the corporate Trustee had discretion to distribute income for the "care, support, maintenance and welfare" of Donald's wife, Arlene, and for the "care, support, maintenance, education and welfare" of Donald's descendants. The Trustee also had discretion to distribute principal to Arlene and to Donald's descendants if trust income and all other available funds were insufficient for their "care, support, maintenance, education, comfort and medical or other attention or emergency." Regarding distributions of income and principal, the Trustee was directed to favor the interests of Arlene over the interests of Donald's descendants. Upon Arlene's death, the trust property was to be distributed to Donald's then living descendants.

The Trustee honored Arlene's annual requests for distribution of all of the net income to her. The Trustee approved a request for a distribution of principal to one of Donald's descendants and denied two other requests from the same descendant. Donald's descendants sued the Trustee for breach of its duties of impartiality and prudent investment. Regarding the allegation that the Trustee breached its duty of impartiality, Donald's descendants asserted that the Trustee put its decision to distribute all net income to Arlene on "auto-pilot" and that its distribution decisions were unreasonable because the Trustee failed to examine and balance all of the beneficiaries' needs and resources.

The trial court held for the Trustee on both counts. Regarding the duty of impartiality, the Missouri Court of Appeals found that the Trustee engaged in a reasoned and well-documented process that the Trustee used periodically to evaluate its distribution decisions. The Court of Appeals ruled that the Trustee did not have to review financial information from each of Donald's descendants before making a distribution decision. The Court of Appeals explained that Arlene was the preferred beneficiary, and the Trustee was not required to balance Arlene's needs against the needs of Donald's descendants. The Court of Appeals concluded that the Trustee's decision to distribute all income to Arlene each year in accordance with her request, even though there was no remaining net income for Donald's descendants, was reasonable.

b. Accustomed Manner of Living. When language such as "accustomed standard of living" or "accustomed manner of living" is included in a discretionary distribution clause, courts have held that the Trustee does not have the power to dictate the beneficiary's standard of living. Rather, such language sets the standard by which the support and maintenance of the beneficiary is to be measured. *See, e.g.*, *In re Estate of McCart*, 847 P.2d 184 (Colo.App. 1992).

The Restatement 3d § 50, cmt. d(2), states that a beneficiary's accustomed manner of living "is ordinarily that enjoyed by the beneficiary at the time of the settlor's death or at the time an irrevocable trust is created." The Comment proceeds to say that the amount of distributions under an accustomed manner of living standard can be adjusted for inflation, the beneficiary's deteriorating health, increased financial burden due to the beneficiary's dependents or, in some instances, to maintain the beneficiary at a higher standard of living to which the beneficiary has become accustomed.

In *In re the G.B. Van Dusen Marital Trust Under the Grosvenor B. Van Dusen Revocable Trust Agreement Dated December 17, 1981, As Amended*, 834 N.W.2d 514 (Minn.App. 2013), the governing instrument of a trust established by Grosvenor B. Van Dusen directed the Trustee, Lowry Hill, to pay the income from a marital trust to G.B.'s wife, Virginia, for her life, and further provided that the Trustee had the discretion to distribute principal to Virginia for her health, education, maintenance and care. The Trustee had no obligation to consider other assets or income available to Virginia. The trust instrument stated that G.B. intended for the Trustee to distribute principal liberally to Virginia to enable her to maintain the standard of living to which she was accustomed during G.B.'s lifetime. Upon Virginia's death, the remaining trust property was to pass into separate trusts for the benefit of G.B.'s descendants.

The Trustee denied multiple principal distribution requests. After the Trustee and Virginia filed petitions for relief regarding the administration of the trust, the district court granted summary judgment in favor of the Trustee, finding that it did not abuse its discretion. On appeal, the Minnesota Court of Appeals held that the Trustee did not have the discretion to deny Virginia's requests for distributions of principal. The court found that G.B.'s intention was to provide for Virginia so as to maintain her standard of living without concern for the preservation of principal, and the Trustee's denial of Virginia's requests was contrary to that intent. The court also determined that the Trustee had a duty to determine Virginia's standard of living at the time of any request for a distribution of principal. Furthermore, although the Trustee had the discretion to consider Virginia's other resources, the Trustee was not permitted to withhold distributions contrary to G.B.'s direction to make liberal distributions of principal to maintain Virginia's standard of living.

3. Proper Drafting of Discretionary Trust Provisions

Although state statutes spell out many Trustee duties and powers, specific instructions in the instrument usually prevail over the statutes. Upon acceptance of a trust, the Trustee should ensure that the trust instrument is clear and determine if there are uncertainties that need to be resolved nonjudicially or judicially.

Reliance on boilerplate distribution language in form documents without ascertaining the settlor's intent for establishing a trust will often result in frustrated beneficiaries and court intervention. It is especially important that the governing instrument reflect the intent of the settlor of the trust as to discretionary distributions. A major issue that has been frequently litigated is whether the beneficiary has an absolute right to support from the Trustee or whether the Trustee's distributions are conditional or discretionary. The trust instrument should as clear as possible regarding the degree of discretion granted to the Trustee.

The administration of trusts that confer upon the Trustee substantial discretionary authority to distribute trust income or principal to a beneficiary involves extra risk. As discussed above, because courts engage in such a fact-sensitive analysis when reviewing a Trustee's decisions in implementing clauses conferring broad distribution discretion, it can sometimes be difficult for Trustees to make the right decisions without seeking court direction. Clear and precise drafting of such clauses can help avoid the delay and costs associated with trust construction litigation.

In addition, if the settlor intends that there be no distributions of principal, the trust instrument should unambiguously reflect that. The trust instrument also should clearly state whether it is the Trustee who has the power to make a given distribution or the beneficiary who has the power to demand the distribution. It is preferable that the Trustee make the distribution decision in most cases.

4. Trustee as a Beneficiary of a Trust

If a Trustee has a beneficial interest in a trust, a transfer of property (discretionary distribution) by the Trustee to or for someone else is not a gift by the Trustee *if* it is made under a fiduciary power the exercise of which is limited by a reasonably fixed or ascertainable standard set forth in the trust instrument. Treas. Reg. § 25.2511-1(g)(2). A reasonably fixed or ascertainable standard includes a beneficiary's education, support, health, maintenance, reasonable comfort as well as meeting an emergency or maintaining an accustomed standard of living. Treas. Reg. § 25.2511-1(g)(2).

In *Gwinn v. Gwinn*, 2016 Ill. App. LEXIS 546 (August 15, 2016), plaintiffs (three of four children of defendant and the Grantor of a trust, defendant's deceased wife) filed suit against the defendant for breach of fiduciary duty in using trust assets to make an extraordinary gift to his second wife, who was not a beneficiary of the trust.

Pursuant to the trust instrument, the Trustee had discretion to make distributions of income to himself, as the primary beneficiary, and also distributions of principal to himself "as the trustee deems necessary or advisable from time to time for his health, support and maintenance in reasonable comfort." The trust instrument also called for discretionary distributions of income and principal to the Grantor's children (the plaintiffs). The trust instrument stated that the Grantor's "primary concern with respect to [her] children [wa]s for their care and education until they bec[a]me self-supporting…."

Following his wife's death, the defendant remarried and subsequently removed at least $425,000 in principal from the trust to pay for a custom-built home which was titled in his new wife's sole name. Plaintiffs alleged that defendant had breached the trust instrument by making an "extraordinary gift" to his new wife, and that the purchase of the home was not necessary for defendant's health, maintenance and support. The Illinois Appellate Court acknowledged that the primary dispute between the parties was the degree of discretion the Grantor intended to give defendant, both as Trustee and primary beneficiary of the trust, in distributing the principal of the trust. The Appellate Court ultimately held that, while the Grantor undoubtedly gave the defendant broad discretion as Trustee to provide for himself as the primary beneficiary, with no particular obligation to support the plaintiffs from the trust assets while he was alive, the defendant could not do whatever he wanted with the trust assets. The Appellate Court ruled that this was not the "exceptional case" where the Trustee had absolute control over the trust assets. Rather, the language in the trust instrument was found to restrict defendant's choices to what he deemed, in his discretion, was "necessary or advisable" to provide for his health, support, and maintenance, and nothing in the trust instrument allowed him to make extraordinary gifts, using trust assets, to his second wife.

B. LOANS TO BENEFICIARIES

1. Advantages and Disadvantages

Loans from assets can be a helpful tool for beneficiaries. Trustees may consider loaning funds to beneficiaries under certain circumstances instead of making a distribution. For example, if a trust does not permit distribution of principal to a beneficiary, the Trustee may still be able to lend trust assets to the beneficiary in order to make funds available for that beneficiary's needs. A loan can sometimes be a more appropriate arrangement than an outright distribution where the beneficiary has a large but illiquid taxable estate and the loan allows funds to be made available to the beneficiary without increasing the beneficiary's taxable estate. Moreover, a secured loan can offer financial assistance to a current beneficiary while still preserving the trust assets for remainder beneficiaries. Wolven, "With Great Power Comes Great Liability: Helping Trustees Avoid Pitfalls in Common Transactions," 51st ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2017).

However, prior to making a loan, the Trustee should be mindful of the circumstances surrounding the loan. The Trustee must first consider whether the trust instrument or applicable law even permits loans to beneficiaries. If permitted, the Trustee should consider whether the beneficiary will definitely be able to repay the loan and ensure that sufficient security is present for the loan. The Trustee should be prepared for the possibility of the beneficiary's defaulting on the loan, and what remedies will then be available to the Trustee to maintain the integrity of the trust. The Trustee should also consider whether there are others who would need to approve any loan. For instance, there may be Co-Trustees all of whom must participate in approving and signing documents approving and implementing the loan. Wolven, *supra.*

2. ***Paradee v. Paradee***

Additionally, the Trustee should consider whether the loan is a good investment, or at least made on terms favorable to the trust. After all, when the Trustee makes a loan, the Trustee is making an investment decision. Wolven, *supra.* In *Paradee v. Paradee*, C.A. No. 4988-VCL, 2010 WL 3959604 (Del. Ch. 2010), following the death of his first wife, William Charles Paradee, Sr. ("Charles, Sr.") married his second wife, Eleanor. Due to Charles, Sr.'s subsequent marriage, his relationship with his children from his prior marriage became strained. However, Charles, Sr. maintained a close relationship with his grandson, Trey, and established the W. Charles Paradee, Sr. Irrevocable Trust (the "Trust") for Trey's benefit.

The Trustee ("Mr. Sterling") utilized funds from the trust to purchase a second-to-die insurance policy on the lives of Charles, Sr. and Eleanor, the projected death benefit of which was $1,150,700. As Charles, Sr.'s health declined, Eleanor sought to control the administration of the Trust. On various occasions, Eleanor attempted to terminate the policy and revoke the Trust for the purpose of liquidating assets to pay a tax liability due and owing on the Paradees' business, but she was never able to accomplish this goal.

Eleanor and Mr. Sterling discussed the alternative of having the Trust loan money to the Paradees' business to pay the tax liability. Mr. Sterling then obtained the advice of counsel to make the loan terms "comparable to those which a commercial bank would offer," which would mean the use of prevailing interest rates, monthly amortization, adequate security and the borrower qualifying for the loan and obtaining a loan commitment. Mr. Sterling then obtained a loan on the policy to fund the Trust's loan to the Paradees. Despite the advice of counsel, Mr. Sterling structured the loan to the Paradees to be unsecured, with fixed interest rates and accruing simple interest rather than compounding, and he allowed the Paradees to pay interest annually instead of monthly.

Mr. Sterling subsequently died, and Eleanor appointed herself Trustee. When Trey was then notified about the existence of the Trust, Trey appointed himself Trustee, and the Paradees' business paid the trust $340,389.04 in principal and interest.

Trey then sued Eleanor and Mr. Sterling's estate for breach of fiduciary duties in making the loan to the Trust. The court found that when Mr. Sterling made the loan to the trust, he breached his duty of loyalty. The court stated that Mr. Sterling was more interested in pleasing his clients, the Paradees, than determining what would be in the best interests of the Trust. The court further explained that "[t]here was no upside to the trust in loaning funds to an entity controlled by the Paradees, and much less so on an unsecured basis and at a fixed rate…." The court also found that Eleanor knowingly participated in Mr. Sterling's breach of fiduciary duty, and concluded that she was liable to the same extent as Mr. Sterling.

3. Distribution Disguised as a Loan

Another concern for Trustees is a distribution disguised as a loan. A trust beneficiary may request a loan from the trust when the requirements for discretionary distribution of principal are not met. Manterfield, "Shelter from the Gathering Storm: Protection for Trustees Facing Fiduciary Challenges," American Bar Association, Real Property, Trust and Estate Law 23rd Annual Spring Symposia 2012. For example, a beneficiary who is scheduled to receive all the trust assets when he reaches age 30 may request that the Trustee "loan" the entire trust principal to the beneficiary at age 27. From the beneficiary's perspective, he or she will receive the funds in three years' time anyway, and interest payments are not necessary because the beneficiary would be the recipient of any income earned on those trust assets. However, a Trustee must consider what can go wrong – the beneficiary may die before he reaches age 30 (and would therefore never have been entitled to receive the trust assets). In such a situation, the Trustee must answer to the remainder beneficiaries as to why the "loan" was ever made. To be safe, if the Trustee cannot directly make a discretionary distribution to the beneficiary, it may be that the Trustee should not make one under the guise of a loan either. Manterfield*, supra.*

C. COURT FINDS THAT BENEFICIARY'S POWER OF WITHDRAWAL IS NOT SUBJECT TO TRUSTEE'S DISCRETION

In re Hamady Trust, 2015 Mich. App. LEXIS 1515 (June 30, 2015)

In 1969, Ernest and Sona Hamady (the "Settlors") established separate revocable trusts (the "Trusts"). After both Sona and Ernest died in 2010, the Trusts continued for the benefit of their four children: Bruce, Charles, Carole and Cynthia. Bruce was the sole Trustee after the Settlors' deaths.

Article VII, Section B of the Trusts' governing instruments stated that the Trustee shall distribute as much of the trust principal as the Trustee "determines necessary for the reasonable health care, education, support and maintenance of the Beneficiary and the Beneficiary's immediate family…." Article VII, Section C included a provision stating that "the Trustee is authorized (but not required based upon power to postpone distributions as herein set forth) to distribute to the Child such amounts of the principal of the Trust named for the Child, even to the extent of exhausting principal, as the Child may from time to time request by written instrument…." Article VIII provided, in relevant part, as follows:

> Notwithstanding any of the provisions of the Trust to the contrary…Trustee of each Trust hereunder…shall have the power to postpone any corpus distribution (including distributions pursuant to the exercise of a right of withdrawal) otherwise required to be made from that Trust to any one or more of its beneficiaries upon or after the beneficiary's exercise of withdrawal right…if such Trustee, in the sole but reasonably exercised discretion of Trustee, determines that, in view of my apparent overall original intent, there is a compelling reason to postpone such distribution….

If the Trustee exercised the power to postpone, the Trustee could make distributions to the beneficiary as the Trustee deemed appropriate for such beneficiary's best interests.

In 2012, Charles filed a petition to remove Bruce as Trustee. In 2013, while that petition was pending, Charles exercised his right of withdrawal under Article VII, Section C, to receive $5,000.00 per month from the Trusts indefinitely. Bruce denied Charles' request and asserted that Charles did not have an absolute right of withdrawal and that all distributions from the Trusts were subject to the Trustee's discretion.

Charles then filed a petition asking a probate court to make a determination that once a beneficiary makes a written request for distribution from that child's trust, the Trustee may refuse the request only if the Trustee had a compelling reason to postpone the distribution under Article VIII. Charles then contended that Bruce must grant Charles' request to withdraw principal from the Trusts because there was no compelling reason postpone a distribution under Article VIII. The probate court denied the petition, stating that Bruce had the discretion to deny Charles' request for principal under Article VII, Section B.

The Court of Appeals of Michigan reversed and remanded, finding that the Trustee's discretion to make distributions of principal under Article VII, Section B did not limit a beneficiary's ability to withdraw principal under Article VII, Section C. The Court of Appeals concluded that the reference to the power to postpone in Article VII, Section C, and the reference to the right of withdrawal in Article VIII should be read to mean that the right of withdrawal was limited only by the Trustee's power to postpone in Article VIII and not the Trustee's discretionary power to make distributions of principal in Article VII, Section B.

The Court of Appeals rejected the Trustee's argument that the power of withdrawal in Article VII, Section C must be subject to the Trustee's discretion because otherwise the beneficiary would hold a general power of appointment, which would conflict with the Settlors' desire to minimize estate taxes. While the Court of Appeals agreed that the Settlors' did have a desire to minimize estate taxes, the Court of Appeals held this intent could not be used to override the plain language of the trust instrument.

D. BENCHMARKS FOR DISTRIBUTIONS

The drafting lawyer and the client have at their disposal a wide variety of benchmarks, beyond traditional references to trust accounting income or principal, that may be used for designing trust distributions. The trust instrument may grant to the Trustee the authority to determine the most appropriate manner to determine the amount of income distributable to a beneficiary each year, even if such determination is inconsistent with applicable state law. Under the Uniform Principal and Income Act ("UPIA"), currently enacted in 45 states and the District of Columbia, the Trustee may have a "power to adjust" between income and principal to, for example, expand the definition of "income" beyond traditional items such as interest, dividends, rents or royalties. *See* UPIA § 104; *see, e.g.*, NY EPTL 11-2.3(b)(5).

Perhaps the most straightforward benchmark for distributions would be an annuity. With an annuity, the trust instrument simply mandates periodic distribution of a pecuniary amount or a fraction or percentage of the initial fair market value of the trust assets. Although the annuity distribution method minimizes the risk of disputes between the Trustee and the beneficiary regarding calculation of the distribution amount, the Trustee has no ability to modify distributions due to changes in circumstances, either with regard to the beneficiary's personal financial situation or changes in the value of the trust assets.

Alternatively, the Trustee may have the authority to make distributions of a unitrust amount, which, in general, is an annually variable distribution to the beneficiary each year based on a fraction or percentage of the fair market value of the underlying trust assets re-determined each year. With a unitrust amount distribution, the drafting attorney should include guidance in the trust instrument for the Trustee to calculate the unitrust amount. This guidance should include direction on the valuation of the trust property, such as the date of valuation. To decrease volatility in the distributions from year-to-year, the trust instrument may direct the Trustee to value the trust property by calculating the average of the trust property values as of the valuation date over a designated number of preceding years. The trust instrument should usually direct that the value of the trust property for purposes of determining the unitrust amount not include property from which the distribution could not be made, such as a residence or tangible personal property held in the trust.

The trust instrument may direct that a unitrust payment is to made out of income and, to the extent income is insufficient, from principal. In addition, the unitrust amount distribution standard need not include a mandate for distributions. The Trustee may be given the authority to make discretionary distributions of a unitrust amount (as a substitute for authority to make discretionary distributions of trust accounting income).

Ethics Issues Facing Trusts & Estates Practitioners

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A. Screening Clients to Avoid Problems Before They Develop

In our zeal to build a book of business, there may sometimes be a temptation, when a potential client presents himself or herself at our door, reflexively to say "yes" without adequately assessing possible negative consequences. However, there are several client intake considerations that should be examined carefully before accepting a new client engagement.

1. Client Desirability

A given prospective client may simply be a person you would be better off not representing. There are several indicators of possible problems, and upon reflection you may conclude you don't want to deal with those problems. Are you the latest in a succession of lawyers or other professional service providers? Does the prospective client display a belligerent attitude? Is the prospective client overtly peculiar or eccentric? Does the prospective client appear to have an unusually controlling personality? When you raise the subject of fees and explain how you propose to charge for services rendered, does that discussion engender a resistant or even hostile reaction?

2. Professional's Ability to Provide What Client Needs

Estate planning is a multi-faceted area of practice, and not many of us have true depth of ability and experience in all estate planning subspecialties. Virtually all estate planning professionals have a strong desire to be of service to all those who seek them out. It can be difficult to tell a prospective client that what he or she needs is not a service we have the expertise or experience to provide, but being honest with a prospective client about our professional capabilities is very important. Examples of estate planning subspecialties with which capable estate planners may lack depth include business succession planning, asset protection planning (particularly, offshore asset protection planning), pre- and post-marital agreements, design and creation of tax-exempt charitable entities.

3. Client's Ability to Pay

An estate planner rightly expects to be compensated fairly and promptly for services performed. An otherwise fine relationship between client and professional advisor may sour quickly if invoices languish. When in doubt, consider requiring a prospective client to provide a retainer. A retainer can be useful in demonstrating not only the prospective client's financial responsibility but also his or her commitment to the project.

4. Conflicts of Interest

Of course, an estate planning professional should strive to avoid any existing or reasonably foreseeable conflicts of interest. Among the many types of conflict of interest that may exist in the estate planning context include conflicts between spouses or partners, a parent and child, the prospective client and a closely-held business entity, the prospective client and an existing client, the prospective client (as beneficiary) and a fiduciary, the prospective client (as fiduciary) and beneficiaries and the prospective client and you. *See*, *e.g.*, *Haynes v. First National State Bank of New Jersey*, 432 A.2d 890 (N.J. 1981); Will of Mann, 490 N.Y.S.2d 213 (1985); *A. v. B. v. Hill Wallack*, 726 A. 2d 924 (N.J. 1999); *Matter of Aoki v. Aoki*, NY Slip Op 02474 (March 31, 2016).

Some actual or potential conflicts of interest are or should be immediately evident. Others may be subtle or perhaps not yet fully developed. It is common for an estate planner to work with both spouses or partners, particularly where the relationship between them is long-term and any children are those of that one, long-term relationship. In such cases, both spouses or partners usually have the same estate planning goals, and, in the initial meeting, it is clear they very compatible.

Other circumstances should cause the estate planner to proceed carefully before agreeing to a concurrent representation of spouses or partners. These circumstances include one spouse or partner appearing to be unduly dominant, the existence of legacy wealth belonging to one spouse or partner, the existence of a closely-held business in which one spouse is deeply involved, the spouses or partners being involved in a second or subsequent marriage or relationship, the existence of children of one spouse or partner, each spouse or partner expressing different dispositive objectives and the spouses or partners displaying a tense or tumultuous relationship.

B. Ethics Dilemmas in Asset Protection Planning

1. Court Finds No Ethical Violation for Representing a Client in a Fraudulent Conveyance

Iowa Supreme Court Attorney Disciplinary Board v. Ouderkirk, 845 N.W.2d 31 (Iowa 2014)

In January 2003, Rodney Heemstra ("Rodney") shot and killed his neighbor, Tommy Lyon. Rodney was eventually convicted of voluntary manslaughter in the criminal trial, and Lyon's family was awarded $5.7 million in damages as a result of a wrongful death action.

Rodney and his wife, Berta Heemstra ("Berta"), were successful farmers whose net worth was over $4 million at the time of the shooting. Just days after the shooting, Mason James Ouderkirk, Rodney's lawyer, wrote to Berta to warn her that any property transfer under the circumstances could be challenged by Lyon's family as a fraudulent conveyance or creditor avoidance and that a court could set such transfers aside. Nevertheless, during January and February of 2003, Ouderkirk drafted numerous documents transferring a majority of the Heemstras' property into four different revocable trusts. The Heemstras told Ouderkirk that the transfers were for cash flow to pay creditors and to pay real estate taxes. The Brisco Revocable Trust held most of the transferred property.

In mid-March 2003, the Heemstras told Ouderkirk that the Appleroon Irrevocable Trust was a potential bona fide purchaser with respect to a majority of the land then held by the Brisco Revocable Trust (hereinafter, the "Appleroon transaction"). Ouderkirk believed the proposed sale was legitimate, as the property had previously been listed for sale. Heemstra requested the sales contract contain the following paragraph:

> **26. CLAIMED ATTACHMENT.** Buyer acknowledges that the Iowa District Court for Warren County has issued a writ of attachment in a pending lawsuit entitled *The Estate of Tommy Ray Lyon vs. Rodney Heemstra* which may be purported to affect title to the real estate described herein, even though Rodney Heemstra is not a party to this transaction. Seller and Buyer are of the opinion that said attachment does not effect [sic] the real estate which is the subject of the contract because it was not in effect and/or filed against the premises at the time Seller acquired title to said real estate. Buyer shall suspend and not make any payments due Seller which are attached, garnished, to be paid to, executed upon, levied upon and/or assigned by, to or for the Estate of Tommy Ray Lyon, or its personal representative, the surviving spouse, heirs or devisees of Tommy Ray Lyon, or successors or assigns and the same shall be added to the principal balance due in the final payment due Seller on April 1, 2033, under this contract but shall not draw or accrue additional or delinquent interest on said deferred payment amounts. Seller shall defend, indemnify and hold Buyer harmless for any losses, damages or other monetary sums arising out of such claim or actions.

Ouderkirk included the paragraph in the contract. Ouderkirk never received proof of consideration for the transaction and was not present at the closing, which was typical of his previous transactions with Rodney. Ouderkirk's representation of the Heemstras concluded following the Appleroon transaction.

Lyon's estate brought collection actions against Rodney asserting that the transfers occurring in the months following Lyon's death were fraudulent conveyances. The district court ruled in favor of the estate, unwinding several transfers and awarding actual and punitive damages to Lyon's estate.

In December 2009, following Rodney's criminal retrial and conclusion of the wrongful death and collection actions, Lyon's widow filed an ethics complaint with the Iowa Supreme Court Attorney Disciplinary Board (the "Board") against Ouderkirk for his involvement in the transfers. Specifically, they alleged a violation of the Iowa Code of Professional Responsibility for Lawyers under rules regarding dishonesty, fraud, deceit or misrepresentation, conduct prejudicial to the administration of justice, action to harass or maliciously injure another and assisting a client in fraudulent conduct. The Board's Grievance Commission found that the Heemstras deceived Ouderkirk as to the nature of and rationale for the transfers, and, therefore, Ouderkirk lacked actual knowledge that the transactions were a sham. However, the Grievance Commission found that paragraph 26 of the sale contract in the Appleroon transaction should have alerted Ouderkirk to the Heemstras' intent and issued a public reprimand for violations of rules governing dishonesty and fraud and malicious injury to another.

Ouderkirk argued that he could not be deemed to have committed fraud under the disciplinary rules because the elements of common law fraud must be proven—"materiality, falsity, representation, scienter, intent to deceive, justifiable reliance, and resulting injury and damage"—and a fraudulent conveyance is not a fraud. Iowa statutes define a fraudulent transfer as one made "with actual intent to hinder, delay, or defraud any creditor of the debtor." Iowa Code § 684.4(1)(a). A fraudulent transfer is also one made "without receiving a reasonably equivalent value" if the debtor would be unable to repay his debts at the conclusion of the transaction. *See* Iowa Code § 684.4(1)(b). Thus, an attorney-at-law must know many details regarding his client's assets and indebtedness in order to violate this standard. The lawyer should be able generally to rely on the client's representations in order to perform his or her duties. The Supreme Court of Iowa had previously ruled that a fraud could be committed under Iowa's Code of Professional Responsibility by fraudulent transactions that do not involve "fraud, dishonesty, or any attempt to deceive."

Ouderkirk also argued that he did not owe a duty to the Heemstras' creditors and therefore could not have violated any disciplinary rule requiring that he avoid inflicting harm on all persons involved in a transaction. Ouderkirk testified that paragraph 26 was merely a condition of the sale. It was not, as the Board maintained, a tool for an illegitimate transfer of property or an attempt to hinder the Lyons' collection on the judgment or other creditors of the Heemstras. Instead, he argued, it was a standard paragraph that any arms-length buyer would have required. Thus, it supported his belief and the Heemstras' representation that the Appleroon transaction was at arms-length.

The Supreme Court dismissed the complaint against Ouderkirk, finding that the Board failed to prove Ouderkirk violated any ethics rules by a convincing preponderance of the evidence. The court stated that just because a lawyer drafted documents for a transaction that was later set aside as a fraudulent conveyance does not mean that the lawyer has committed fraud under the disciplinary rules. Significantly, the court found numerous facts that would have indicated to Ouderkirk, based on his previous transactional history with the Heemstras, that the Appleroon transaction was a legitimate, arms-length purchase of the Heemstras' property. To determine whether a fraudulent conveyance occurred, the court looks for "badges of fraud" such as "inadequacy of consideration . . . secrecy or concealment, [and] departure from usual business methods" among other things. The court found that none of these existed for Ouderkirk at the time of the Appleroon transaction. That the sale was not bona fide was the main fact supporting fraudulent conveyance, not the inclusion of paragraph 26 in the sales contract.

Furthermore, because Ouderkirk did not know the transaction was fraudulent at the time he drafted the documents, Ouderkirk could not have violated professional rules requiring a lawyer to abstain from conduct involving dishonesty, fraud, deceit or misrepresentation. A violation of this standard requires a "knowing misrepresentation," which Ouderkirk did not make.

In addition, Ouderkirk's conduct was not prejudicial to the administration of justice. The Board claimed Ouderkirk's conduct was prejudicial because Lyon's estate was forced to engage in costly litigation to collect. The Supreme Court, however, generally finds that this rule is implicated only if there is a violation of another rule. The court found that the Heemstras' misrepresentation caused the litigation, and Ouderkirk did not violate any other rules, so he could not have engaged in prejudicial conduct.

2. Eleventh Circuit Denies Summary Judgment for Lawyer Who Deposited Debtor Funds into Trust Account to Avoid Creditors

Martinez v. Hutton (In re Harwell), 628 F.3d 1312 (11th Cir. 2010)

On July 12, 2005, the debtor in this bankruptcy case, Billy Jason Harwell, suffered a judgment against him in the amount of $1.396 million payable to Thomas Clay Hill. On July 27, 2005, Mr. Hill commenced a proceeding in Sarasota County, Florida to collect on the judgment. Mr. Harwell was represented in this matter by a lawyer named Steven Hutton.

At this time, Mr. Harwell was a shareholder of the Center for Endoscopy, Inc. ("CFE") and was a member of Sarasota Endo Investors, LLC ("SEI"). In August of 2005, he liquidated his interests in these entities, receiving $500,000 in cash and a $46,837 promissory note from SEI. Later that month, when Mr. Harwell was answering interrogatories for the proceeding to collect the judgment against him, Mr. Harwell did not disclose the funds due him from liquidating his interests in these entities. Mr. Hutton was not involved in Mr. Harwell's responses to these interrogatories.

On September 1, 2005, CFE dispersed $100,000 to Mr. Harwell. The funds were deposited into Mr. Hutton's trust account. On the same day, Mr. Hutton, at Mr. Harwell's direction, and with knowledge of Mr. Hill's collection efforts, disbursed $90,000 of these funds, $65,000 of which were disbursed to Mr. Harwell or his wife. On September 9, 2005, SEI then distributed $400,000 to Mr. Hutton's trust account to liquidate Mr. Harwell's interest. Again, on the same day, Mr. Hutton, at Mr. Harwell's direction, disbursed the $400,000 to various payees. After these checks were written but before they cleared, Mr. Hill obtained a turnover order requiring Mr. Harwell to turn over any payments from SEI and turn over any funds Mr. Harwell received after July 12, 2005 that were still within his control.

On September 19, 2005, Mr. Hill then served Mr. Hutton with a writ of garnishment for any amounts held in the trust account for Mr. Harwell. Mr. Hutton and Mr. Harwell, however, convinced the Florida court to quash the writ.

On October 10, 2005, Mr. Harwell filed for bankruptcy under chapter 7 of the Bankruptcy Code. On November 19, 2005, the Bankruptcy Trustee filed a complaint against Mr. Hutton seeking the return of $500,000 from SEI and CFE under 11 U.S.C. §§ 548(a)(1)(A) and 550(a)(1). Mr. Hutton moved for summary judgment, which the Bankruptcy Court granted.

Under Section 548 of the Bankruptcy Code, the Bankruptcy Trustee may avoid any transfer made by the debtor within two years before filing the bankruptcy petition if the transfer was made "with actual intent to hinder, delay or defraud" any current or future creditors. Under Section 550(a)(1), if a transfer is avoided, the Bankruptcy Trustee may recover the property transferred or, if the Bankruptcy Trustee obtains a court order, the value of such property from the "initial transferee of such transfer."

On appeal to the United States Court of Appeals for the Eleventh Circuit, the main issue was whether Mr. Hutton was an initial transferee, which would allow the Bankruptcy Trustee to recover from Mr. Hutton the $500,000 placed in Mr. Hutton's trust account and distributed to Harwell, his family members and certain creditors.

The Eleventh Circuit explained that the transferee of an avoidable transfer is an initial transferee only if the transferee exercises legal control over the assets received, such that the transferee has the right to use the assets for his own purposes and not if he merely served as a conduit for assets that were under the actual control of the debtor-transferor or the real initial transferee. A "mere conduit" cannot be considered an initial transferee for purposes of an avoidance action. This "mere conduit rule" is used most frequently in situations where banks act as an intermediary in transferring assets. The Eleventh Circuit stated that the conduit rules presume that the facilitator of the funds acts without bad faith and is simply an innocent participant in the fraudulent transfer.

Thus, initial recipients of a debtor's fraudulently-transferred funds who wish to satisfy the conduit or control test must establish that: (a) the recipient did not have control over the assets received, *i.e.*, the recipient merely served as a conduit for the assets that were under the actual control of the debtor-transferor; and (b) the recipient acted in good faith and as an innocent participant in the fraudulent transfer.

The Eleventh Circuit then applied these rules to determine Mr. Hutton's role in Mr. Harwell's fraudulent transfers. The Eleventh Circuit observed that the Bankruptcy Court assumed, for purposes of the summary judgment motion, that Mr. Hutton was the "mastermind" of this fraudulent conveyance scheme. Furthermore, the Bankruptcy Court assumed the transfers into and out of Mr. Hutton's trust account were made to defraud creditors such as Mr. Hill.

The Eleventh Circuit concluded that Mr. Hutton was an initial transferee because he received the funds and deposited them into his trust account. The Eleventh Circuit then considered whether Mr. Hutton could use the conduit or control defense. The Eleventh Circuit, breaking new legal ground, held that the conduit or control defense would be unavailable to Mr. Hutton unless he had acted in good faith. The Eleventh Circuit reversed the Bankruptcy Court's decision granting Mr. Hutton's summary judgment motion. Because the Bankruptcy Court had not heard evidence regarding the good faith issue, the Eleventh Circuit remanded the case for the Bankruptcy Court to consider that issue.

3. Ethics Considerations in Counseling Clients to Take Advantage of Creditor Protection Strategies

Practitioners must consider the ethical implications of assisting clients in avoiding bankruptcy and other forms of asset protection. While none of the provisions under the Model Rules specifically discuss asset protection planning, the language of the some of the Model Rules could encompass such services. One such Rule is Model Rule 1.2(d), which states as follows:

> A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

Under the Model Rules, "fraud" and "fraudulent" mean "conduct that is fraudulent under the substantive or procedural law of the applicable jurisdiction and has a purpose to deceive." Model Rule 1.0(d). This definition seems to include more than just a fraudulent conveyance but does not seem to apply to conduct that is merely intended to frustrate or impede the transferor's creditors. Lischer, Jr., *Professional Responsibility Issues Associated With Asset Protection Trusts*, 39 REAL PROP. PROB. & TR. J. 562 (2004). Model Rule 1.0(f) provides that the Model Rules are not violated unless it is found that the lawyer possessed actual knowledge of the conditions that violate a Model Rule. However, a lawyer's knowledge may be inferred from the surrounding circumstances.

Cases and ethics opinions discussing the ethical implications of asset protection planning, some of which are discussed below, generally show that a practitioner might be in violation of applicable ethical rules if the practitioner helps a client to defraud known or foreseeable creditors, especially if the practitioner is licensed in a state that does not recognize self-settled trusts. However, no ethical violation should occur if the advice pertains to unknown and unforeseeable creditors. *See* Nenno, *Planning With Domestic Asset-Protection Trusts, Part I*, 40 REAL PROP. PROB. & TR. J. 263 (Summer 2005).

Another Model Rule that may implicate asset protection planning is Model Rule 1.3, which mandates "reasonable diligence and promptness in representing a client." Comment 1 states that "[a] lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf."

Two more provisions could arguably implicate asset protection services: (a) Model Rule 4.4(a) states that, "[i]n representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person… ." and (b) Model Rule 8.4 states that "[i]t is professional misconduct for a lawyer to:… (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation… ."

In Connecticut Informal Opinion 91-22 (Dec. 5, 1991), the Connecticut Bar Association's Committee on Professional Ethics had to determine whether a lawyer may advise or assist with respect to a transfer from a debtor-client to the client's spouse under Connecticut's version of Model Rules 1.2(d), 8.4(c) and 4.4. With regard to Model Rule 1.2(d), the Opinion stated that "where the lawyer is aware of the client's intent to in some manner directly benefit from or control the property transferred while trying to deprive creditors of access to that property there is a purpose to deceive and if the lawyer counsels or assists the client in carrying out the transaction, the lawyer will violate Rule 1.2(d)." The lawyer must have actual knowledge that the purpose of the transfer is the avoid creditors.

With regard to Model Rule 8.4(c), the Opinion stated that a transfer would violate this Rule if the following requirements were met: (a) the transaction is a fraudulent transfer; (b) the lawyer knows the transaction is a fraudulent transfer; (c) the lawyer knows of a purpose to deceive creditors or that there is no other substantial purpose than to burden or delay creditors; and (d) the lawyer either counsels or assists the client in carrying out the transfer.

With regard to Model Rule 4.4, the Opinion stated that a fraudulent transfer delays and burdens creditors by forcing them to choose either: (a) not to challenge the fraudulent transfer and suffer the loss of an uncollected debt; or (b) to file an action to set aside the fraudulent transfer with the attendant costs in terms of time and money. The Opinion also stated that, if "there is a demonstrable and lawful estate planning purpose to the transfer," Model Rule 4.4 would not apply. The Opinion indicated that a retained benefit or control over transferred property, while attempting to deprive creditors of access to the property, indicates a purpose to deceive. While the facts of the Opinion were insufficient to determine clearly whether an ethical violation occurred, the Opinion seemed to indicate that each of the above Rules would be violated.

Some courts considering disciplinary matters have discussed whether asset protection planning is ethical. The general finding of these cases is that the very purpose of a trust primarily created for asset protection purposes is to frustrate creditors and the courts while the transferor enjoys continuing control over, or a beneficial interest in, the property transferred. In *Florida Bar v. Klein*, 774 So. 2d 685 (Fla. 2000), for example, it was alleged that a lawyer participated in a corporation's fraudulent transfer by preparing documents that created a second corporation for the purpose of minimizing the effects of bankruptcy. The court found that the lawyer violated Florida's version of Model Rule 8.4(d), which precludes "conduct prejudicial to the administration of justice."

In *In re Kenyon*, 491 S.E.2d 252 (S.C. 1997), after the debtor's death, the lawyers assisted in an improper conveyance of real property to avoid creditors of the probate estate. The court found that the lawyers violated South Carolina's version of Model Rule 1.2(d) by assisting the debtor's estate in engaging in criminal or fraudulent conduct. The court stated that it did not need to consider whether the transfer was a fraudulent conveyance under applicable state law. *But see* Connecticut Informal Opinion 91-22, *supra*; South Carolina Bar Ethics Advisory Committee, Op. 84-02 (1984) (both concluding that a transfer must be a fraudulent transfer under applicable state law before a lawyer may be sanctioned).

C. Representing Clients with Diminished Capacity

1. Recognizing a Client's Disability

Even if a client has the requisite testamentary capacity to execute estate planning documents, a client's level of capacity may substantially affect his or her decisions regarding the estate plan. The estate planner can play a vital role in determining whether a client with diminishing capacity is making rational, informed decisions free of undue influence. This determination is often difficult because clients with diminishing capacity will often try to disguise their problems by, for example, dressing professionally and avoiding complicated subjects. The following characteristics may be commonly displayed by a client who has testamentary capacity but is experiencing a significant decline in mental acuity:

- The client may not be able to summarize the estate planning issues discussed or otherwise show an understanding of the issues. The client may also respond to questions about these issues with short and over-simplified answers or by quickly deferring to the judgment of the estate planner or a close relative.

- The client is unable to explain his or her motivations, feelings or behaviors. Explanations may be limited to "just keeping the status quo" or "this is what my [deceased] husband wanted."
- The client may make sudden, drastic changes in his or her dispositive desires.
- The client may be unable to remember very recent discussions and may repeat stories and statements during the same meeting or conversation.

Frolik, "Dealing with the Partially Incapacitated Client: How to Prevent Financial Abuse, Undue Influence and Other Ills of Aging," American College of Trust and Estate Counsel, 2011 Summer Meeting; Tedford, "The Client With Marginal Capacity," American College of Trust and Estate Counsel, 2011 Summer Meeting; Wang, "How to Recognize and Represent Clients with Diminished Capacity," American College of Trust and Estate Counsel, 2006 Annual Meeting. If possible, the estate planner should attempt to observe these characteristics over time and not just from a single meeting. A rapid decline in capacity may become apparent when the client exhibits a significant change in speech, appearance, mood or judgment from one meeting to the next. Wang, supra. Such observations also may allow the estate planner to determine when the client has more lucid intervals. Thus, when engaged by a client who may have diminishing capacity, the estate planner should discuss the client's estate planning over multiple, shorter meetings. This technique also may help the client avoid getting tired before the conclusion of the meeting and allow the estate planner to determine the time of the day during which the client will most likely have the mental capacity to engage in a productive discussion. Rosepink, "Assessment of Older Adults With Diminished Capacity: A Handbook for Lawyers," American College of Trust and Estate Counsel, 2006 Annual Meeting.

2. General Ethics Standards for Dealing With a Client's Disability

Model Rule 1.14 ("Client with Diminished Capacity") sets forth standards specifically applicable when a client has diminished capacity. Model Rule 1.14(a) makes it clear that the lawyer's duty to the client does not end simply because the client may be disabled. Specifically, Model Rule 1.14(a) provides that the lawyer should "as far as reasonably possible, maintain a normal client-lawyer relationship with the client." This includes maintaining adequate communication with the client to determine the client's objectives and goals and the ways in which to achieve them. Model Rule 1.14(b), discussed in more detail below, permits the lawyer to take protective actions for the client in certain circumstances. This may, depending on the circumstances, include seeking guidance from medical diagnosticians or others to ascertain the client's mental state or petitioning a court for the appointment of a guardian. Model Rule 1.14, ABA Comments 5 & 6. Model Rule 1.14(c), also discussed in more detail below, addresses the disclosure of confidential information of a disabled client.

When the client clearly lacks capacity, a lawyer should withdraw from representation (or decline to start the representation). If capacity is uncertain, the lawyer should document in detail the lawyer's observations of the client's mental and physical state. This documentation will be crucial in determining the validity of an estate plan if a conflict arises. Kahn, Barton & Lau, "Steer Clear of Conflicts of Interest in Estate Planning," ESTATE PLANNING, Nov. 2016.

3. Taking Protective Actions.

a. <u>General Rules Under Model Rule 1.14(b)</u>. Model Rule 1.14(b) gives the lawyer discretion to take "reasonably necessary protective action" for a disabled client, provided that the lawyer reasonably believes that the client: (1) has diminished capacity; (2) is at risk of substantial physical, financial or other harm unless action is taken; and (3) cannot adequately act in the client's own interest. The ABA, in ABA Formal Opinion 96-404 (August 2, 1996), provided that any protective action sought should be "the least restrictive under the circumstances." The ABA Comment to Model Rule 1.14(b) also reminds lawyers that state law may actively require the lawyer to advocate the least restrictive action on behalf of the client. Model Rule 1.14, ABA Comment 7. Further, the ACTEC Commentaries on the Model Rules of Professional Conduct (5th Ed. 2016) (the "ACTEC Commentaries") adds that the lawyer should consider the impact the lawyer's actions may have on potential challenges to the client's estate plan.

b. <u>Seeking Appointment of A Guardian</u>. Seeking appointment of a guardian for a disabled client is an extreme measure and should not be undertaken lightly. Several states, including New York and Oregon, have taken stances similar to Model Rule 1.14 in their ethics opinions regarding when a lawyer may seek appointment of a guardian for his or her client. For example, in New York State Ethics Commission, Opinion Number 746 (July 18, 2001), the Commission concluded that a lawyer who also serves as the client's attorney-in-fact may petition for the appointment of a guardian without the client's consent only if the lawyer determines that the client is incapacitated and that there is no practical alternative, through the use of the power of attorney or otherwise, to protect the client's best interests. Similarly, Oregon State Bar Ass'n Bd. of Governors, Formal Opinion 1991-41, concluded that the lawyer "must reasonably be satisfied that there is a need for protective action and must then take the least restrictive form of action sufficient to address the situation."

Notably, in the California State Bar Standing Committee on Professional Responsibility and Conduct, Formal Op. No. 1989-112 (1989), the Committee ruled that a lawyer could not ethically institute a conservatorship proceeding for a client he or she believed to be incompetent if it was against the client's express wishes and doing so would require the lawyer to violate his or her client's confidences and represent potentially conflicting interests, even if the lawyer believed that a conservatorship for the client would be in client's best interests. The Committee noted that the lawyer may withdraw under such circumstances.

Generally, if a guardian is appointed for the client, the lawyer should assist the guardian for the client's benefit. However, if the lawyer reasonably believes that the guardian is not acting in the client's best interests, the lawyer may be obligated to act contrary to the guardian to protect the client's interests. *See In re Makarewicz*, 516 N.W.2d 90 (Mich.App. 1994); *see also*, Alaska Ethics Op. 87-2 (1987). The ACTEC Commentaries to Model Rule 1.14 provide that the lawyer may have such an obligation even if the lawyer represents the guardian.

c. <u>Other Protective Measures</u>. In addition to appointing a guardian, the ABA Comment to Model Rule 1.14 provides that the protective measures a lawyer may take with respect to a disabled client include: (1) consulting with family members; (2) using a reconsideration period to permit clarification or improvement of circumstances; (3) using voluntary surrogate decision-making tools such as durable powers of attorney; and (4) consulting with adult-protective agencies, other governmental agencies or other individuals or entities that have the ability to protect the client. The Comment further explains that, in taking any protective action, the lawyer should consider the wishes and values of the client, the client's best interests and the goals of limiting intrusion into the client's decision-making autonomy, maximizing client capacities and respecting the client's family and social connections. Model Rule 1.14, ABA Comment 5.

D. Obligations of Lawyer After Representation Has Become Dormant

1. Duty to Monitor Affairs of Client to Ensure That Estate Plan is Not Frustrated by Subsequent Actions

This issue was addressed in *Stangland v. Brock*, 747 P.2d 464 (Wash. 1987). In 1979, a lawyer named Norman Brock prepared a Will for Ralph Schalack that left all of his real property to Alvin Stangland and Bruce Kintschi. At the time the Will was signed, Mr. Schalack's farm was the substantial asset of his estate. The residue of the estate was bequeathed to different individuals.

In February 1982, Kenneth Carpenter, a real estate lawyer practicing in the same law firm as Mr. Brock, prepared a sales contract for the Mr. Schalack's farm. Mr. Brock was not aware that the property was being sold. Mr. Carpenter stated that he had no knowledge of the terms of Mr. Schalack's Will.

Mr. Schalack died on May 7, 1982. Messrs. Stangland and Kintschi brought an action against Messrs. Brock and Carpenter and their law firm seeking damages for professional negligence. Specifically, the complaint alleged that Mr. Brock was negligent in not drafting the Will to provide that the farm (or sales proceeds thereof) would ultimately pass to the Messrs. Stangland and Kintschi, as was the intent of the decedent. In addition, the lawyers were alleged to be negligent by not advising Mr. Schalack that entering into the sale of the property would frustrate the intent under his Will.

The court found that, notwithstanding that Mr. Brock was a member of the same law firm as Mr. Carpenter, Mr. Brock had no duty to advise the decedent of the contract's possible effect on his estate plan. The court stated that such a duty would expand "the obligation of a lawyer who drafts a will beyond reasonable limits." The court added that, after fulfilling his or her obligation to draft a will in accordance with the testator's wishes, "the attorney has no continuing obligation to monitor the testator's management of his property to ensure that the scheme established in the will is maintained." The court further found that Mr. Carpenter had no reason to know of the contents of the Mr. Schalack's Will and could not have foreseen that the sale of the property may harm the respondents.

2. Model Rule 1.4 and Dormant Representation

Model Rule 1.4 provides that a lawyer must keep his or her clients reasonably informed about the status of a matter and promptly comply with reasonable requests for information and shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions.

The ACTEC Commentaries to Model Rule 1.4 introduces the concept of "dormant representation" as follows:

> The execution of estate planning documents and the completion of related matters, such as changes in beneficiary designations and the transfer of assets to the trustee of a trust, normally ends the period during which the estate planning lawyer actively represents an estate planning client. At that time, unless the representation is terminated by the lawyer or client, the representation becomes dormant, awaiting activation by the client. . . . Although the lawyer remains bound to the client by some obligations, including the duty of confidentiality, the lawyer's responsibilities are diminished by the completion of the active phase of the representation. As a service the lawyer may communicate periodically with the client regarding the desirability of reviewing his or her estate planning documents. Similarly, the lawyer may send the client an individual letter or a form letter, pamphlet, or brochure regarding changes in the law that might affect the client. <u>In the absence of an agreement to the contrary, a lawyer is not obligated to send a reminder to a client whose representation is dormant or to advise a client of the effect that changes in the law or the client's circumstances might have on the client's legal affairs</u>. (emphasis added).

> The ACTEC Commentaries provide the following examples:

> Example 1.4-1: Lawyer (L) prepared and completed an estate plan for Client (C). L performed no other legal work for C in the following two years but has no reason to believe that C has engaged other estate planning counsel. L's representation of C is dormant. L may, but is not obligated to, communicate with C regarding changes in the law. If L communicates with C about changes in the law, but is not asked by C to perform any legal services, L's representation remains dormant. C is properly characterized as a client and not a former client for purposes of [Rules] 1.7 and 1.9.

> Example 1.4-2: Assume the same facts as in Example 1.4-1 except that L's partner (P) in the two years following the preparation of the estate plan renders legal services to C in matters completely unrelated to estate planning, such as a criminal representation. L's representation of C with respect to estate planning matters remains dormant, subject to activation by C.