The School of Law
University of California, Los Angeles,
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Present

The Thirty-seventh Annual

UCLA-CEB ESTATE PLANNING INSTITUTE

Reference Materials

May 2015

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May 2015

ES-41080
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PREFACE

These materials were prepared for the 37th Annual UCLA-CEB Estate Planning Institute, presented May 1st and 2nd, 2015, in Los Angeles, California.

The School of Law, University of California, Los Angeles, and Continuing Education of the Bar wish to express deep appreciation to the Institute's distinguished faculty for participating in the Institute and preparing these materials.

The success of the annual Institute is the result of the generous participation of these nationally known experts and the continued efforts of the Advisory Board, chaired by Monica Dell'Osso and Paul Gordon Hoffman.

The Institute serves as a forum for experienced attorneys and tax specialists to work together in analyzing and examining the complex issues of planning for substantial estates. The Institute further serves to provide authoritative information on aspects of estate administration, statutory, case law and pending legislation and how it affects estate planning practice and other issues of concern to experienced estate planning attorneys.

As in past years, CEB intends to publish the updated version of the papers and make them available, fully indexed, in a bound volume.

Pamela J. Jester
Executive Director, CEB

The 37th Annual UCLA-CEB Estate Planning Institute
May 1 & 2, 2015

SCHEDULE

Friday, May 1, 2015

8:00 am – 8:45 am *Registration and Continental Breakfast*

8:45 am – 9:00 am Welcome and Introductions
Monica Dell'Osso, Burnham Brown, Oakland
Paul Gordon Hoffman, Hoffman, Sabban & Watenmaker, APC, Los Angeles

9:00 am – 9:45 am Federal Tax Update (*Part 1*)
Charles D. (Skip) Fox IV, McGuireWoods LLP, Charlottesville, Virginia

9:45 am – 10:00 am *Break*

10:00 am – 10:45 am Federal Tax Update (*Part 2*)
Charles D. (Skip) Fox IV, McGuireWoods LLP, Charlottesville, Virginia

10:45 am – 12:15 pm Bifurcating Trustee Duties: Drafting, Tax, and Administrative Considerations
Dan Schrauth, JP Morgan Private Bank, San Francisco
Linda Retz, Law Offices of Linda Retz, Torrance

12:15 pm – 1:45 pm *Hosted Luncheon*
An Attorney's Guide to Ethically Navigating the Social Media Landscape
Mary K. deLeo, Weintraub Tobin Chediak Coleman & Grodin, Sacramento

1:45 pm – 2:00 pm *Break*

2:00 pm – 3:15 pm Icicles on the Heart: The Effect of Advising a Client/Trustee with Uncertain Capabilities and Toward a Fiduciary Standard of Capacity
John Hartog, Hartog & Baer PC, Orinda

3:15 pm – 3:30 pm *Break*

3:30 pm – 5:00 pm Estate Planning to Avoid Litigation: Ways to Turn What May Seem Inevitable to Avoidable
Stacie Nelson, Holland & Knight, San Francisco
Eric Tokuyama, Holland & Knight, Los Angeles

The 37th Annual UCLA-CEB Estate Planning Institute
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SCHEDULE

Saturday, May 2, 2015

7:30 am – 8:00 am	*Continental Breakfast*
8:00 am – 9:15 am	California Developments **Andy Pharies,** DLA Piper LLP, San Diego
9:15 am – 9:30 am	*Break*
9:30 am – 10:45 am	Portability: Drafting Considerations, Preparation of Returns for Portability Election (Rev. Proc 2000-38) **Erin E. Norberg,** DLA Piper LLP, San Diego
10:45 am – 12:15 pm	International Estate Planning: Owning Assets in a Foreign Country **Michael Rosen-Prinz,** McDermott, Will & Emery, Los Angeles
12:15 pm – 12:30 pm	*Break*
12:30 pm – 1:30 pm	Gift Taxes: Disclosure, Penalties, and Statutes of Limitations - Avoiding a Blank Check for the Internal Revenue Service **Avram Salkin,** Hochman, Salkin, Rettig, Toscher & Perez, P.C., Beverly HIlls

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In Memoriam

Geraldine Hemmerling, 86, of Los Angeles, CA, passed away December 20, 2014. Gerry graduated from UCLA (1949) and UCLA law school (1952) with the very first class. She was President of the UCLA Law Alumni Association (1974), first Chairperson of the UCLA-CEB Estate Planning Institute, a member of their Advisory Board (1978-1985) and President of the American College of Trust and Estate Counsel (1979). In 1990 she received the UCLA Award for Professional Achievement by the UCLA Alumni Association. She authored numerous articles and books and lectured at tax institutes across the country. Prior to her death she was Of Counsel at Hirsch Wallerstein Hayum Matlof + Fishman, LLP.

Jon Joseph Gallo, April 19, 1942 - June 7, 2014, passed away after a 19-month battle with cancer. He graduated from Hollywood High School, Occidental College, and UCLA Law School. In 1967, Jon joined the law firm Greenberg & Glusker, and began what would become a nationally recognized career in Estate Planning. Jon had a brilliant mind and was an extremely gifted speaker.

Harold Weinstock, 89, passed away on December 1, 2014. Harold Weinstock was a pioneer in the field of estate planning, writing numerous articles, teaching a well-known estate planning course at UCLA Extension for almost 25 years and authoring *Planning an Estate*: *A Guidebook of Principles and Techniques*, which was one of the first and most widely used textbooks on estate planning.

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About the Speakers

CHARLES D. ("SKIP") FOX IV, McGuire Woods, Charlottesville, VA, is a partner in the Charlottesville, Virginia office of the law firm of McGuire Woods LLP and head of its Private Wealth Services Industry Group. Prior to joining McGuire Woods in 2005, Skip practiced for 25 years with Schiff Hardin LLP in Chicago. Skip concentrates his practice in estate planning, estate administration, trust law, charitable organizations, and family business succession.

He teaches at the American Bankers Association National Trust School and National Graduate Trust School where he has been on the faculty for 25 years. Skip was an Adjunct Professor at Northwestern University School of Law, where he taught from 1983 to 2005, and is currently an Adjunct at the University of Virginia School of Law. He is a frequent lecturer across the country at seminars on trust and estate topics. In addition, he is a co-presenter of the long-running monthly teleconference series on tax and fiduciary law issues sponsored by the American Bankers Association.

Skip has contributed articles to numerous publications and is a regular columnist for the *ABA Trust Letter* on tax matters. He was a member of the editorial board of *Trusts & Estates* for several years and was Chair of the Editorial Board of *Trust & Investments* from 2003 until 2012. Skip is a member of the CCH Estate Planning Advisory Board. He is co-editor of *Making Sense of the 2010 Estate Tax Legislation* (CCH 2011) and *Estate Planning Strategies after Estate Tax Repeal: Insight and Analysis* (CCH 2001). He is also the author of the *Estate Planning With Life Insurance* volume of the CCH Financial Planning Library, and a co-author of four books, *Estate Planning Manual* (3 volumes, 2002), *Tax Law Guide, Glossary of Fiduciary Terms*, and *Fiduciary Law and Trust Activities Guides*, published by the American Bankers Association.

Skip is a Fellow and Past Regent of the American College of Trust and Estate Counsel (for which he serves on the Communications, Estate and Gift Tax, and Legal Education Committees) and is listed in *Best Lawyers in America*. In 2008, Skip was elected to the NAEPC Estate Planning Hall of Fame. He is also Chair of the Duke University Estate Planning Council and a member of the Princeton University Planned Giving Advisory Council. Skip has provided advice and counsel to major charitable organizations and serves or has served on the boards of several charities, including Episcopal High School (from which he received its Distinguished Service Award in 2001) and the University of Virginia Law School Foundation.

He received his A.B. from Princeton, his M.A. from Yale, and his J.D. from the University of Virginia. Skip is married to Beth, a retired trust officer, and has two sons, Quent and Elm.

Dan Schrauth is a Managing Director with J.P. Morgan Private Bank in San Francisco and Palo Alto, serving ultra-high net worth clients in Northern California and Hawaii. As part of the Private Bank's 50+ member worldwide tax and estate planning advisory team, Dan works with individuals and families on tax efficient wealth transfer strategies. Dan has significant experience advising a wide range of clients including: Silicon Valley/technology entrepreneurs and executives; public company executives; principals of venture, private equity and hedge funds; cross border/international families; and multi-generational wealthy families. Prior to joining J.P. Morgan in 2006, Dan practiced tax, trust and estate law at the San Francisco office of Morgan, Lewis & Bockius, and prior to Morgan Lewis, at the San Francisco office of Hanson Bridgett. Dan is a frequent speaker on wealth preservation and estate planning topics, and has been quoted in publications including The Wall Street Journal, The New York Times, BusinessWeek, The Financial Times and The San Francisco Chronicle.

Dan holds a degree in political science from the University of Vermont and a law degree from the University of San Francisco. Dan lives with his wife and three children in Marin County, California.

Linda J. Retz is a Fellow of the American College of Trust and Estate Counsel ("ACTEC") and chairs the Engagement Letters Subcommittee of ACTEC's Professional Responsibility Committee. She is certified as a specialist in Estate Planning, Trust and Probate Law by the State Bar of California Board of Legal Specialization and is a former Chair of the California State Bar's Estate Planning, Trust and Probate Law Advisory Commission.

Ms. Retz has lectured and written extensively, including for the UCLA/CEB Estate Planning Institute, the U.S.C. Tax Institute, the U.S.C. Trust and Estate Conference and the California CPA Education Foundation. She has been named one of the Best Lawyers in America every year since 2010, as well as being selected as a California Super Lawyer every year since that honor's inception in 2004.

Mary K. deLeo is senior counsel with the law firm of Weintraub Tobin Chediak Coleman Grodin Law Corporation in Sacramento, California. Her practice focuses on trust and estate litigation, estate planning, trust and estate administration, conservatorships, fiduciary representation, special needs trust planning and administration, planning for incapacity, Medi-Cal planning, and elder law.

In addition to estate planning for both small and large-size estates, Mary has successfully represented clients in trust and probate litigation controversies, including trust and will contests, beneficiary/trustee disputes, fiduciary abuse claims, accounting issues, and elder abuse claims. She has also successfully assisted clients with public benefit eligibility issues, including defending a $3 million special needs trust from disqualification by the U.S. Social Security Administration.

Mary received her J.D. degree, summa cum laude, from Western State University College of Law. She is a past chair of the Estate and Gift Tax Committee of the Taxation Section of the California State Bar and currently serves as a volunteer member of the Incapacity Committee, Trusts and Estates Administration Committee, and Ethics Committee of the Trusts and Estates Section of the California State Bar. She is also vice-chair of the Probate and Estate Planning Section of the Sacramento County Bar Association. She is a member of the Trusts and Estates and Taxation Sections of the California State Bar, the Sacramento County Bar Association, the National Academy of Elder Law Attorneys, and the Sacramento Estate Planning Council.

John Hartog possesses particular expertise in estate planning, counseling trustees administering living trusts, and in resolving disputes among beneficiaries and fiduciaries. Mr. Hartog also serves as a mediator in trusts and estates disputes. He is a fellow of the American College of Trust and Estate Counsel and certified by the California Board of Legal Specialization as a Specialist in Taxation Law and in Estate Planning, Trust and Probate Law. He is a former chair of the Executive Committee of the State Bar of California's Trust and Estates Section and a past Chair of the Estate Planning, Trust and Probate Law Advisory Commission to the California Board of Legal Specialization. Mr. Hartog has been selected to the *Super Lawyers*® Top 100 list by his peers for ten consecutive years. Mr. Hartog is co-author of *California Trust Litigation, California Trust Practice* and *California Wills & Trusts*, all used by professionals, and the author of numerous published articles. He is also a legal consultant to the California Wills and Trusts document assembly program. Mr. Hartog has served as a lecturer at the University of California, Berkeley Law School where he taught "Wills and Trusts." Mr. Hartog has lectured at the ALI-ABA Advanced Estate Planning Institutes, the California CPA Education Foundation, the UCLA-CEB Estate Planning Institute, the USC Probate and Trust Conference, the Chaminade University Hawaii Tax Institute, and other sponsored programs from Boston to Honolulu. He holds an L.L.M. (Taxation) from Golden Gate University of Law, his J.D. degree from Hastings College of the Law, and his B.A. degree from Pomona College.

Stacie Polashuk Nelson is a member of the Holland & Knight LLP's Private Wealth Services Group. Since 1998, Ms. Nelson has focused on assisting clients in all aspects of contentious trust, estate and conservatorship matters. Ms. Nelson concentrates her practice on trust and estate litigation, including will and trust contests, disputed

conservatorships, breach of fiduciary duty matters, financial elder abuse matters, as well as trust and estate administration. She is an experienced trial attorney, but she is dedicated to finding the best resolution for the client, including client counseling, mediation, settlement negotiation and litigation through trial. Her administration practice focuses on assisting clients with post-death administration of trusts and estates and securing and protecting bequests made to charitable beneficiaries. Ms. Nelson's clients include families, individuals, charities, and professional and institutional fiduciaries.

Eric M. Tokuyama is a senior counsel in the Private Wealth Services Group in Holland & Knight's Los Angeles office. Mr. Tokuyama graduated *summa cum laude* from Pepperdine University's School of Law and obtained his LL.M. in Taxation from NYU. Mr. Tokuyama practices in the areas of tax and estate planning, probate and trust administration, and probate and trust litigation. He has more than 18 years of experience and is dedicated to helping high-net-worth individuals achieve their estate planning goals. Mr. Tokuyama is well-versed in all aspects of probate and trust administration, including the preparation and filing of federal estate tax returns. With respect to probate and trust disputes, Mr. Tokuyama has a thorough understanding of the requisite legal knowledge and a substantial background in cases that involve disputes between fiduciaries and beneficiaries.

S. Andrew Pharies is a partner with DLA Piper LLP (US) in its San Diego office where he is a member of the firm's Trusts and Estates Group and Global Private Client Group. Mr. Pharies is a Fellow of the American College of Trusts and Estates Counsel and serves on its Programs Committee. He also serves on the Advisory Board for the UCLA-CEB Estate Planning Institute. He previously served as a member and advisor to the Executive Committee of the Trusts and Estates Section of the State Bar of California, where he served as Chair of the Section's Income and Transfer Tax Subcommittee and as Editor-in-Chief of the *California Trusts and Estates Quarterly*. Mr. Pharies is a Certified Specialist in Estate Planning, Trust and Probate Law; he is listed in *Best Lawyers in America* for Trusts and Estates; and he has been repeatedly named a San Diego and Southern California Super Lawyer in Estate Planning & Probate Law. Mr. Pharies is a frequent speaker on domestic and international trusts and estates topics and has previously spoken for ACTEC, the UCLA-CEB Estate Planning Institute, the USC Tax Institute, CEB, ALI-ABA, the State Bar of California Trusts and Estates Section, the ABA Real Property Probate and Trust Section, the CPA Education Foundation, and various local bar associations and estate planning councils. Mr. Pharies has also written on various trusts and estates topics in the *California Trusts and Estates Quarterly*; the *Tax Management Estates, Gifts and Trusts Journal*; *Probate and Property*; and the Matthew Bender Practice Guide, *California Trust Litigation*, Mr. Pharies received his BS from the University of California, Riverside, and his JD from the

University of Oregon School of Law, where he served as Editor-in-Chief of the *Oregon Law Review*.

Erin Norberg is Of Counsel with DLA Piper LLP, (US), San Diego. Erin concentrates her practice in all aspects of sophisticated and basic estate, gift and generation-skipping transfer (GST) tax planning for individuals and families, as well as life insurance trust planning, grantor trust planning, charitable giving, and post-death estate and trust administration.

Michael Rosen-Prinz is a partner in the law firm of McDermott Will & Emery LLP and is based in the Firm's Los Angeles office. Michael focuses his practice on domestic and international estate planning, charitable planning and post death administration.

Michael has lectured on international estate planning and taxation for multiple chapters of the Cal-CPA Association as well as the Trust and Estates Section of the Beverly Hills Bar Association. Michael is also a member of the Executive Committee of the Trust and Estates Section of the Beverly Hills Bar Association.

While in law school, Michael was co-Editor-in-Chief of the *Berkeley Journal of Employment and Labor Law* and Editor-in-Chief of *Boalt Briefs.* Additionally, Michael received the American Bankruptcy Institute's Medal of Excellence and four Prosser Prizes. Michael is admitted to practice in California.

Avram Salkin is a founding member of Hochman Salkin Rettig Toscher & Perez, P.C. and has over fifty years of extensive experience in resolving complex federal and state tax controversies and disputes. He is a Certified Specialist in both Taxation and Estate Planning, Trust and Probate Law.

He has received the Dana Latham Award for a lifetime of achievement in taxation from the Los Angeles County Bar Association and was the recipient of the Joanne M. Garvey Award given by the Taxation Section of the State Bar of California for lifetime excellence in the practice of tax law.

Mr. Salkin is a former Member of the Board of Governors of the Beverly Hills Bar Association, Chair for the Tax Advisory Commission for the California State Bar Board of Legal Specialization, and Chair of both the Business Law Section and the Taxation Section of the Beverly Hills Bar Association. He also served on the Executive Committee of the Taxation Section of the Los Angeles County Bar Association and was the Tax Articles Editor of the Los Angeles County Bar Journal.

Avram Salkin's many lectures include presentations at the ABA Section of Taxation, the University of Southern California Institute on Federal Taxation; California CPA

Education Foundation Conferences (Member, Planning Committee, Pass-Thru Entities Conference); the Los Angeles County and Beverly Hills Bar Associations; programs by the California Continuing Education of the Bar on real estate taxation, professional corporations, partnership taxation, and tax procedure; and the California State University Continuing Education Program in real estate taxation. He has also written on many tax-related subjects, including real estate taxation, S corporations, operating loss carryovers, employment tax issues, attorney-client privilege matters, and partnership tax issues.

Mr. Salkin is admitted to practice before the U.S. Tax Court, the U.S. District Court for the Central District of California, the United States Court of Appeals for the Ninth Circuit, and the U.S. Supreme Court. He received his undergraduate degree, with honors in accounting, from the University of California at Los Angeles and his law degree from the University of California, Berkeley. Avram Salkin holds an “A-V” rating from Martindale-Hubbell.

The 37th Annual UCLA/CEB Estate Planning Institute

Federal Tax Update

May 2015

Charles D. Fox, IV

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Recent Developments

Presented by:

Charles D. Fox IV
cfox@mcguirewoods.com

1. State of the Union Surprise (January 17, 2015)

- **President targets inherited assets in middle class tax reform**

2. The Administration's Estate Tax Budget Proposals for Fiscal Year 2016 and Related Items (February 2, 2015)

- **Obama Administration's Budget Proposal for fiscal year 2016 could affect estate planning**

3. 2014-2015 Priority Guidance Plan (August 26, 2014)

- **IRS issues Priority Guidance Plan**

4. Foreign Account Tax Compliance Act (FATCA)

- **FATCA takes effect in 2014**

5. Revenue Procedure 2014-61, 2014-47 IRB 860 (October 30, 2014)

- **IRS provides the 2015 inflation adjusted amounts for tax exemptions, deductions, brackets, and other items**

6. Letter Ruling 201406004 (Issued October 25, 2013; released February 7, 2014)

- **IRS grants an estate an extension of time to make the portability election**

7. Revenue Procedure 2014-18 (January 27, 2014)

- **Portability election made easier for estates of decedents who died before 2014, but executors of decedents who die in 2014 or later are still subject to stricter time limits**

8. Letter Ruling 201442015 (Issued July 15, 2014; released October 17, 2014)

- **IRS concludes that an estate was not entitled to an extension to make a carryover basis election for a 2010 decedent because the executor failed to act in good faith**

9. Letter Ruling 201410011 (Issued November 9, 2013; released March 7, 2014)

- **Spouse's right to elect under revocable trust is not a "contingency" which disqualifies a gift for the estate tax marital deduction and the marital deduction will be allowed for the distribution of preferred units in limited liability company to a QTIP marital deduction trust**

10. Letter Ruling 201406003 (Issued September 13, 2013; released February 2, 2014)

- **IRS concludes that trustee is entitled to an extension of time to notify the IRS that decedent's spouse, who is the beneficiary of a qualified domestic trust, has become a United States citizen**

11. Letter Ruling 201421006 (Issued February 11, 2014; released May 23, 2014)

- **IRS grants extension of time to allow trustee to amend trust to meet the requirements for qualified domestic trusts**

12. Letter Ruling 201431019 (Issued April 10, 2014; released August 1, 2014)

- **Extension of time to file notice that spouse has become a United States citizen granted**

13. Letter Ruling 201431004 (Issued April 16, 2014; released August 1, 2014)

- **Extension of time to file notice that spouse has become a United States citizen granted**

14. CCA 201416007 (April 18, 2014)

- **No marital deduction permitted to extent that elective share is to be satisfied with assets in a trust in a foreign country held for the benefit of child**

15. Estate of Olsen, T.C. Memo 2014-58

- **IRS holds that assets in a QTIP Trust should be included in the estate of the surviving spouse**

16. Letter Ruling 201426016 (Issued March 11, 2014; released June 27, 2014)

- **Division of QTIP Marital Deduction Trust into three separate trusts will create three separate QTIP Trusts; termination of third trust will not cause spouse to be deemed to have made a gift of the property in the other two trusts and no gain or loss would be recognized; termination of third trust will not cause first two trusts to fail to qualify as QTIP Trusts at Decedent's death**

17. Estate of Davidson v. Commissioner, T.C. Docket No. 13748-3

- **IRS challenges self-cancelling installment note**

18. Estate of Donald Woelbing v. Commissioner (Tax Court Docket No. 30261-13, petition filed Dec. 26, 2013) and Estate of Marion Woelbing v. Commissioner (Tax Court Docket No. 30260-13, petition filed Dec. 26, 2013); Estate of Jack Williams v. Commissioner (Tax Court Docket No. 29735-13, petition filed Dec. 19, 2013)

- **Sweeping IRS Attacks on time-honored techniques**

19. Letter Rulings 201410001 – 201410010 (Issued October 21, 2013; released March 7, 2014)

- **IRS addresses gift and estate tax consequences of incomplete non-grantor trusts**

20. Letter Rulings 201430003 and 201430004 (Issued February 7, 2014; released July 25, 2014)

- **Service rules favorably on a form of incomplete non-grantor trust**

21. Letter Rulings 201436008 (Issued December 27, 2013; released September 5, 2014) and 201436032 (Issued December 30, 2013; released September 5, 2014)

- **IRS rules on tax consequences of incomplete non-grantor trusts**

22. Letter Rulings 201510001-201510008 (Issued October 10, 2014; released March 6, 2015)

- **Favorable rulings on incomplete non-grantor trusts**

23. Letter Ruling 201403005 (Issued September 19, 2013; released January 17, 2014)

- **Taxpayer's proposed disclaimers of contingent rights to interests in two irrevocable trusts will not be subject to gift tax**

24. Letter Rulings 201435007 through 201435010 (Issued April 23, 2014; released August 29, 2014)

- **Life tenants and remaindermen of pre-October 9, 1990 trust will not be treated as making a taxable gift when a trust is modified**

25. Estate of Sanders, T.C. Memo 2014-100

- **Tax Court denies motion for summary judgment with respect to whether gifts were adequately disclosed thereby triggering the running of the limitations period for assessment of additional gift tax**

26. I.L.M. 201442053 (October 17, 2014)

- **IRS concludes that the recapitalization of a limited liability company was a transfer from a donor to her two children under Chapter 14**

27. <u>Cavallaro v. Commissioner</u>, T.C. Memo 2014-189

- **Tax Court holds that husband and wife are liable for gift tax following company merger**

28. Letter Ruling 201442042 (Issued June 18, 2014; released October 17, 2014)

- **Modification of a trust to correct scrivener's errors will permit desired tax consequences for grantor retained annuity trust**

29. Letter Rulings 201427010-20147015 (Issued February 24, 2014; released July 3, 2014)

- **Beneficiary's testamentary power of appointment is not a general power of appointment causing inclusion of the trust property in the beneficiary's gross estate**

30. Letter Rulings 201438010 through 201438013 (Issued May 2, 2014; released September 19, 2014)

- **Powers of appointment have neither adverse lifetime nor testamentary tax consequences**

31. Letter Ruling 201429009 (Issued March 18, 2014; released July 18, 2014)

- **Family trust not includable in gross estate of decedent except for value of the 5 by 5 power held by decedent**

32. Letter Ruling 201436036 (Issued May 21, 2014; released September 5, 2014)

- **Power of appointment reformed by court order to be a non-general power will not constitute a general power of appointment for estate tax purposes**

33. Letter Rulings 201446001 – 201446011 (Issued July 14, 2014; released November 14, 2014)

- **Service holds that power of appointment granted to grandchild in trust is not a taxable general power of appointment**

34. Estate of Kessel v. Commissioner, T.C. Memo 2014-97

- **Tax Court concludes that Internal Revenue Service is not entitled to summary judgment with respect to the value of a personal pension plan that decedent had and which was invested with Bernard L. Madoff**

35. Riegels v. Commissioner (In re Estate of Saunders), 745 F.3d 953 (9th Cir. 2014)

- **Ninth Circuit upholds disallowance of an estate's deduction for a contingent claim for which the estimated value on the date of death was not reasonably ascertainable, but allows the deduction of the subsequent settlement amount**

36. Estate of Richmond v. Commissioner, T.C. Memo 2014-26

- **Tax Court determines value of decedent's interest in a family-owned personal holding company using a net asset value method and imposes a 20 percent accuracy-related penalty for substantial undervaluation on estate tax return**

37. Elkins v. Commissioner, 767 F.3d 443 (5th Cir. 2014)

- **Fifth Circuit reverses Tax Court and allows estate tax discounts for fractional interests in artwork**

38. Giustina v. Commissioner, Unpublished Opinion (9th Cir. 2014)

- **Ninth Circuit reverses decision of Tax Court in valuation case in which the issue was the amount of the discount for a minority interest in a limited partnership**

39. <u>Gust Kalapodis v. Commissioner</u>, T.C. Memo 2014-205

- **Tax Court concludes that taxpayers are not entitled to an income tax charitable contribution deduction for scholarship payments made by irrevocable trust created in memory of deceased son**

40. <u>Whitehouse Hotel Ltd. Partnership v. Commissioner</u>, 755 F.3d. 236 (5th Cir. 2014)

- **Court of Appeals affirms Tax Court's ruling disallowing a significant portion of a tax deduction for historic conservation easement but permits the use of the good faith exception to prevent imposition of a 40% gross overstatement penalty**

41. Letter Rulings 201421023 and 201421024 (Issued February 25, 2014; released May 23, 2014)

- **IRS concludes that annuity payments from charitable lead annuity trusts pursuant to the terms of previously executed charitable pledge agreements will not constitute self-dealing**

42. <u>Schmidt v. Commissioner</u>, T.C. Memo 2014-159

- **Government loses on valuation of conservation easement**

43. Letter Ruling 201321012 (Issued February 1, 2013; released May 24, 2013)

- **IRS rules favorably on tax consequences of gift of unitrust interest in charity**

44. Letter Ruling 201426006 (Issued February 28, 2014; released June 27, 2014)

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45. Letter Ruling 201450003 (Issued August 20, 2014; released December 12, 2014)

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46. Belk v. Commissioner, 774 F.3d 221 (4th Cir. 2014)

- **Husband and Wife are not entitled to an income tax charitable contribution deduction for a donation of a conservation easement on a golf course because the easement agreement allowed for substitutions of property**

47. Mitchell v. Commissioner, ____ F.3d ____ (10th Cir. 2015)

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48. Letter Ruling 201406008 (Issued October 21, 2013; released February 7, 2014)

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49. Letter Ruling 201418001 (Issued January 9, 2014; released May 2, 2014)

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50. Letter Ruling 201422005 (Issued January 23, 2014; released May 30, 2014)

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51. Letter Ruling 201418005 (Issued December 12, 2013; released May 2, 2014)

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52. Letter Ruling 201425007 (Issued February 25, 2014; released June 20, 2014)

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53. Letter Ruling 201438016 (Issued May 28, 2014; released September 19, 2014)

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54. Letter Ruling 201432004 (Issued March 19, 2014; released August 8, 2014)

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55. Letter Ruling 201432005 (Issued March 5, 2014; released August 8, 2014)

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56. Letter Ruling 201450002 (Issued August 12, 2014; released December 12, 2014)

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65. Clark v. Rameker, ____ U.S. ____, 134 S. Ct. 2242 (June 12, 2014)

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66. Treasury Regulation § 1.67-4 (May 8, 2014)

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68. Wyly v. United States, 2014 U.S. Dist. LEXIS 135671 (September 24, 2014)

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74. Specht v. United States, __ F. Supp. 2d ___ (S.D. Ohio 2015)

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37th Annual UCLA/CEB Estate Planning Institute

Federal Tax Update

May 1, 2015
9:00 a.m. – 10:45 a.m.

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The McGuireWoods Private Wealth Services Group

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FEDERAL TAX UPDATE[1]

LEGISLATIVE PROPOSALS AND IRS GUIDANCE

1. State of the Union Surprise (January 17, 2015)

President targets inherited assets in middle class tax reform

After the American Taxpayer Relief Act of 2012, many in the estate planning community thought that tax law dealing with estates and trusts was settled for some time. President Obama's earlier budget proposals calling for a higher rate and a lower exemption (among other changes) and the Republican support for the repeal of the estate tax were seen by many as *pro forma* budgetary proposals. But on January 17, 2015, President Obama released his tax relief proposal for middle class families. Included in the plan are expanded child care, education, and retirement tax benefits and other tax credits to support working families. To pay for these provisions, the President proposes to:

- Eliminate the "stepped-up" basis rules in the Internal Revenue Code, treating bequests and gifts as realization events subject to capital gains tax;
- Increase top capital gains and dividend tax rates; and
- Impose a fee on the liabilities of large U.S. financial firms.

This new proposal comes at the start of a new Congress, with both the House and Senate controlled by Republicans unlikely to give such a plan any room on the legislative agenda. These selected individual tax changes signal a rhetorical, if not a substantive shift, for the White House from the common ground of comprehensive business tax reform to the perceived inequality of individual income tax system.

Deconstructing the Trust Fund Loophole

With some rhetorical license, the White House fact sheet describes Internal Revenue Code section 1014 as the "trust fund loophole" and goes on to suggest that it may be "the largest single loophole in the entire individual income tax code." This Code section provides that "the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent…be the fair market value of the property at the date of the decedent's death…" The basis of an appreciated asset is said to be "stepped-up" at death.

The fact sheet describes a situation where a person inherits stock worth $50 million. Working with that example, if at a mother's death she passes that stock to her daughter, the daughter's basis in the stock will be $50 million. Under current law, if the daughter immediately sells the stock no capital gains tax will be paid because the basis was stepped-up at the mother's death. The fact sheet fails to point out that the estate of the mother would pay somewhere between $15.6 million and $20 million in federal estate tax at a 40% rate, depending on the availability of

[1] This outline is based upon materials prepared by Ronald D. Aucutt, Keonna Carter, W. Birch Douglass, III, Michele A. W. McKinnon, Charles D. Fox IV, and William I. Sanderson of McGuireWoods LLP. Copyright © 2015, McGuireWoods LLP. All rights reserved.

the deceased mother's unified credit against estate tax available. And in any one of 19 states (and the District of Columbia), the mother's estate would owe state estate tax as well. Under President Obama's proposal, the mother's death would not only trigger the payment of estate tax, but it would be a realization event giving rise to possible capital gains tax.

Revenue by Realization Event

Under current law, capital gain is treated as income and taxed only when property is disposed of or sold. The regulations under IRC section 1001 identify capital gain income (or loss) as "the gain or loss from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or extent." Gifts are not sales, and unless the transfer of stock is in fulfillment of a specific bequest or dollar amount, transfers at death are not realization events. Under current law, no capital gains tax is paid when those transfers occur.

In order to raise more revenue and to raise it immediately, the President's proposal *must* change this rule and treat the transfer of assets by gift or at death as realization events. If the proposal alone eliminated the stepped-up basis regime, no capital gains tax would be due until assets were sold. A stated goal for new regime would be to unlock this capital. To unlock capital, and to raise revenue immediately, the capital gains must be realized at the time of these transfers. And if transfers by gift and at death are realization events, capital gains taxes would be owed on the appreciation – the difference between the basis and the fair market value – at the time of the transfer, regardless of whether the asset is in fact sold or exchanged.

Continuing the example from above highlights the impact of this proposed rule on taxpayers. The transfer at death, from mother to daughter, would be a realization event. In addition to the estate tax paid by the mother's estate, an estimated $11 million in capital gains tax would be due at the time of transfer. The proposal is unclear if the capital gains tax will be paid by estate of the mother (or the transferor, if it had been a gift) or the daughter. But it is clear additional tax will be due. This proposal seems to resemble the current Canadian system of taxing capital gains at the death of each decedent. Canada replaced its estate tax system, in part, by enacting the system of taxing capital gain any time an assets is transferred (by gift, at death, on sale, or upon removal from Canada) in 1971.

The Administration's proposal may also increase taxpayers' exposure to state income tax in those states that tax capital gains based on federal revenue.

Increasing the Tax Rate

Having restored the tax on earned income to higher rates previously seen under President Clinton, this proposal turns to President Reagan for the historical benchmark for the highest rate on capital gains. In addition to imposing the capital gains tax on these transfers, the President proposes to increase the total top capital gains and dividend tax rate to 28 percent.

Middle Class Protection

The President intends this proposal to target "those at the top" and provides exemptions that are designed to benefit middle-class taxpayers.

- The fact sheet implies that transfers between spouses would be exempt from the realization treatment. Like the marital deduction eligible for gifts or transfers at death, this exemption would effectively defer the payment of capital gains tax until the death of second spouse unless the asset is sold in the interim.
- The fact sheet states that gifts at death of appreciated assets to charity would be exempt from this capital gains tax.
- Each married couple would be allowed to transfer up to $200,000 of capital gains ($100,000 for an individual taxpayer) free of capital gains tax. The exemption is described as automatically portable between spouses.
- In addition to the basic exemption (described above), each married couple would have an additional $500,000 exemption for personal residences (or $250,000 for an individual taxpayer).
- Tangible personal property (other than "expensive artwork and similar collectibles") would be exempt from capital gains tax, freeing families from the burden and expense of creating inventories and appraisals for income tax purposes.
- Tax on inherited family-owned and operated businesses would not be due unless the business was sold, and closely-held businesses would have the option to defer tax on capital gains over time.

What's Next for Taxpayers

The fact sheet released by the White House falls short of a detailed legislative proposal. More details on how the plan would be implemented are expected when the budget process starts in February. What is clear now, however, is that the proposal will face strong objection in the 114th Congress.

While it is unlikely to be part of any comprehensive tax reform, this proposal will join other proposals from the Obama Administration, including limitations on grantor trusts and a minimum term for GRATs, in the library from which ideas for raising revenue may be drawn in the future. It will also form part of the tax reform debate for both Democrats and Republicans headed into the 2016 election cycle.

2. The Administration's Estate Tax Budget Proposals for Fiscal Year 2016 and Related Items (February 2, 2015)

Obama Administration's Budget Proposal for fiscal year 2016 could affect estate planning

On February 2, 2015, the Administration released its "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals," which is often referred to as the "Greenbook," to accompany its proposed Fiscal Year 2016 Budget. The 2015 Greenbook

clarifies the President's proposal in his 2015 State of the Union Address to "close the trust fund loophole" by treating the transfer of appreciated property during life or at death as a realization event for capital gains tax purposes. It also continues proposals from past Greenbooks and modifies certain of those prior proposals.

New Proposal – Increasing the Capital Gains Tax Rate and "Closing the Trust Fund Loophole"

As discussed in the President's State of the Union Address, the Administration proposes to increase the highest long-term capital gains and qualified dividend tax rate from 20 percent to 24.2 percent. The 3.8 percent net investment income tax would continue to apply as under current law. The maximum total capital gains and dividend tax rate including net investment income tax would consequently rise to 28 percent.

The Administration describes the proposal on treating transfers as realization events as follows:

> Under the proposal, transfers of appreciated property generally would be treated as a sale of the property. The donor or deceased owner of an appreciated asset would realize a capital gain at the time the asset is given or bequeathed to another. The amount of the gain realized would be the excess of the asset's fair market value on the date of the transfer over the donor's basis in that asset. That gain would be taxable income to the donor in the year the transfer was made, and to the decedent either on the final individual return or on a separate capital gains return. The unlimited use of capital losses and carry-forwards would be allowed against ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any). Gifts or bequests to a spouse or to charity would not be subject to the tax. Instead, gifts or bequests to a spouse or to charity would carryover the basis of the donor or decedent. Capital gain would not be realized until the spouse disposes of the asset or dies, and appreciated property donated or bequeathed to charity would be exempt from capital gains tax.
>
> The proposal would exempt any gain on all tangible personal property such as household furnishings and personal effects (excluding collectibles). The proposal also would allow a $100,000 per-person exclusion of other capital gains recognized by reason of death that would be indexed for inflation after 2016, and would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (making the exclusion effectively $200,000 per couple). The $250,000 per person exclusion under current law for capital gain on a principal residence would apply to all residences, and would also be portable to the decedent's surviving spouse (making the exclusion effectively $500,000 per couple).
>
> The exclusion under current law for capital gain on certain small business stock would also apply. In addition, payment of tax on the appreciation of certain small family-owned and family operated businesses would not be due until the business is sold or ceases to be family-owned and operated. The proposal would further

> allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made.

This proposal would be effective for gifts made and decedents dying on or after January 1, 2016. Most commentators believe that this proposal is dead on arrival.

Continuation of Proposals from Prior Greenbooks

Revisitation of Estate Tax Rates and Exemptions. The Greenbooks for the last six years, all the years of the Obama Administration, have proposed permanently setting the estate, gift, and GST taxes at 2009 levels, in which the top rate was 45 percent and the exemptions (technically "exclusion amounts") were $3.5 million for the estate and GST taxes and $1 million for the gift tax, not indexed for inflation. Even though the rate and exemption for these taxes were permanently set in January 2013 at 40 percent and $5 million indexed since 2011, the current Greenbook renews the call to return to 2009 levels, beginning in 2018. It also calls for the "portability" of the exclusion amount between spouses to be permanently retained. By 2018 there will be a new President and there will have been one more congressional election, and it is hard to guess why 2018 is used. But it certainly does not appear to call for any immediate estate planning action.

Modification of the Gift Tax Annual Exclusion. The 2015 Greenbook continues the proposal first made in the 2014 Greenbook to modify the gift tax annual exclusion. The 2015 Greenbook cites Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), and points out that the use of "*Crummey* powers" has resulted in significant compliance costs, including the costs of giving notices, keeping records, and making retroactive changes to the donor's gift tax profile if an annual exclusion is disallowed. The Greenbook adds that the cost to the IRS of enforcing the rules is significant too.

The Greenbook also acknowledges an IRS concern with the proliferation of *Crummey* powers, especially in the hands of persons not likely to ever receive a distribution from the trust, and laments the IRS's lack of success in combating such proliferation (citing Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991); Kohlsaat v. Commissioner, T.C. Memo 1997-212).

The Greenbook offers the following explanation of the proposal:

> The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without regard to the existence of any withdrawal or put rights), and would impose an annual limit of $50,000 per donor on the donor's transfers of property within this new category that will qualify for the gift tax annual exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of $50,000 would be taxable, even if the total gifts to each individual donee did not exceed $14,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

As to interests in passthrough entities, see the IRS successes in Hackl v. Commissioner, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003) (interests in an LLC engaged in tree farming); Price v. Commissioner, T.C. Memo 2010-2 (interests in a limited partnership holding marketable stock and commercial real estate); Fisher v. United States, 105 AFTR 2d 2010-1347 (D. Ind. 2010) (interests in an LLC owning undeveloped land on Lake Michigan).

The proposal would be effective for gifts made after the year of enactment. It is estimated to raise revenues by $2.924 billion over 10 years.

This is what apparently would be left as excludable gifts:

> Unlimited gifts directly for tuition or medical expenses under section 2503(e).
>
> Gifts up to $14,000 (currently) per donee per year, or $28,000 if split, consisting of:
>
> > outright gifts and
> >
> > gifts to trusts described in section 2642(c)(2) – that is, "tax-vested" trusts exempt from GST tax. This latter provision would effectively permit "2503(c) trusts" to any age (not just 21).
>
> Up to $50,000 annually of "mad money" for anything that is otherwise impermissible or at least suspect. There would not have to be an arguable basis for the annual exclusion under current law. (The Greenbook provides the simple example of "transfers in trust.")

Expand Applicability of the Definition of Executor. The 2015 Greenbook also contains the proposal first made in the 2014 Greenbook to expand the definition of "executor" in Section 2203. The Internal Revenue Code currently defines executor as the executor or administrator of the decedent's estate, or, if none, then "any person in actual or constructive possession of any property of the decedent." This could include the trustee of a decedent's revocable trust, an IRA or life insurance beneficiary, or a surviving joint tenant of jointly owned property. The current definition does not give the executor the ability to act on behalf of a decedent with regard to a tax liability that arose prior to a decedent's death. Some actions that an executor currently cannot by law take include extending the statute of limitations, claiming a refund, agreeing to a compromise or assessment, or pursuing judicial relief. Problems also arise if there is no appointed executor and multiple persons meet the definition of "executor."

The proposal would make the Internal Revenue Code's definition of executor applicable for all tax purposes including acting on behalf of the decedent with respect to pre-death tax liabilities or obligations. The proposal would also grant regulatory authority to adopt rules to resolve conflicts among multiple executors.

Grantor Trusts. A "grantor trust" is treated as "owned" by the grantor (creator) of the trust during the grantor's lifetime or some shorter period. As a result, after the grantor makes a gift to an irrevocable grantor trust, with the grantor's descendants, for example, as beneficiaries, the income tax on that trust's income must be paid by the grantor, even though the income belongs to the trust and its beneficiaries. That permits the grantor to make income tax payments that benefit the trust and its beneficiaries without treating those payments as additional gifts.

Grantor trust treatment also permits transactions between the trust and the grantor without income tax, including sales without capital gain and payment of interest without creating taxable income. That feature has supported the popular and effective estate planning technique of an installment sale to a grantor trust, in which assets are sold to the trust for a promissory note with lenient terms (especially at today's low interest rates), often with a small "down payment." The future appreciation in the value of those assets in excess of the modest interest rate escapes gift and estate tax. The trust can also last for multiple generations and be made exempt from the generation-skipping transfer (GST) tax by allocation of the grantor's GST exemption. That feature of grantor trusts also permits fine-tuning or updating the assets of the trust by the grantor's exchange of assets with the trust, again without capital gain or gift treatment.

In the 2012 Greenbook, for the first time, the Administration proposed changes to the estate and gift taxation of grantor trusts treated as owned by the grantor for income tax purposes. As written, those proposals appeared designed to treat all such grantor trusts as fully subject to estate tax when the grantor dies or to gift tax if grantor trust status ceases during the grantor's life. Observers did not believe that such a sweeping change was intended, and we waited for clarification in this year's version of the proposal.

This 2015 Greenbook (as did the 2013 and 2014 Greenbooks) narrows the proposal. It will not apply to all grantor trusts. It will subject to estate tax (or gift tax) only "the portion of the trust attributable to the property received by the trust" from the grantor in an installment sale or similar transaction. The reference to "the portion of the trust" includes the growth in the value of that property, income earned from that property, and the reinvestment of the proceeds of any sales of that property. The amount subject to gift or estate tax will be reduced by the consideration paid by the trust in the sale, presumably including the face amount of the promissory note in most cases. But, of course, the amount of that consideration is typically a fixed amount, while the assets that are sold are usually expected to increase in value.

If enacted as proposed, this change would apply to sales after the date the President signs the law and would effectively eliminate all typical estate tax benefits of such sales and end the use of such sales in the manner to which we have become accustomed. All future appreciation in the assets that are sold would be subject to estate tax no matter how long the grantor lives and whether or not the note is paid off. Attempts to avoid that by terminating grantor trust status during the grantor's life or making distributions from the trust would be subject to gift tax. Because that portion of the trust would be subject to estate tax, the grantor would be unable to allocate GST exemption to it.

If legislation along these lines is enacted, we believe that there would still be some estate tax value in installment sales to irrevocable trusts that are not grantor trusts. But those advantages would be significantly reduced, and many donors would prefer the more predictable benefits of a grantor retained annuity trust (GRAT). Some efforts might be made to design workarounds, possibly including expanded use of the technique of turning grantor trust status on or off, but those techniques would likely attract close scrutiny by the Internal Revenue Service.

There is some comfort, however, in the Greenbook proposal that the legislation authorize Treasury to create exceptions from the proposed estate tax treatment. Those exceptions could

include helpful "safe harbors" that relax the rules in the case of sales that meet certain standards. But it is most unlikely that we will know those exceptions and standards before the legislation is enacted. And it is hard to tell what the legislative prospects are. Estimated to raise revenue of slightly over a billion dollars over ten years, the proposal will not be irresistible as a weapon against deficits, but its appeal in an every-little-bit-helps environment is impossible to predict.

Meanwhile, then, anyone considering an installment sale to a grantor trust should consider completing it, not as a rush project but without avoidable long delay or inattention, which is usually good advice for any estate planning actions like this. Some of those installment sales might be made to trusts that were created and funded in the surge of gift-giving in 2012 when the future of the gift tax exemption was uncertain.

Minimum Ten-Year Term for GRATs and Other Changes. A grantor retained annuity trust is economically similar to an installment sale to a grantor trust, in that it protects from estate tax the appreciation in excess of the interest rate used to calculate the amount of the gift when property is transferred to the GRAT and the grantor retains a stream of annual payments for a stated term. Sometimes GRATs are seen as even preferable to installment sales, because GRATs follow a clear and predictable pattern set forth in tax regulations. One disadvantage of a GRAT is that it will be subject to estate tax, but only if the grantor dies during the stated term. For that reason, many GRATs have had relatively short terms, such as two years.

This year's proposal modifies the identical proposal made in the 2012, 2013, and 2014 Greenbooks. As in the past proposals, the 2015 Greenbook would require a GRAT to have a minimum term of ten years. A new proposal in the 2015 Greenbook would eliminate the common practice of "zeroing-out" by designing the annuity to produce a very low gift tax value by requiring the remainder interest to have a minimum value of the greater of 25 percent of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed. It would also prohibit decreases in the annuity during the term and prohibit the grantor from engaging in any tax-free exchange of assets in the trust. Finally, the proposal would prohibit the GRAT from having a term that extended more than ten years beyond the life expectance of the grantor at the time the GRAT was created.

As with this proposal in the past, it is hard to estimate its prospects, although a similar proposal was approved by the House of Representatives in three rather partisan votes in 2010 under Democratic control, and this proposal is estimated to raise almost $3.9 billion over ten years. As with the proposal regarding installment sales, the lesson is that GRATs under consideration should probably be completed if it is reasonable to do so, again not necessarily in a rush but with reasonable dispatch.

Change in GST Tax Rules for "Health and Education Exclusion Trusts" ("HEETs"). A health and education exclusion trust (or "HEET") is a complex and uncertain technique. It builds on the statutory rule that distributions from a trust that is not exempt from GST tax directly for a beneficiary's school tuition or medical care or insurance are not generation-skipping transfers, no matter what generation the beneficiary is in. By including charities as permissible beneficiaries with somewhat vague interests, the designers of such trusts hope to avoid a GST tax on the

"taxable termination" that would otherwise occur as interests in trusts pass from one generation to another.

The 2015 Greenbook repeats the proposal that was new in the 2013 and 2014 Greenbooks and that would limit the exemption of direct payments of tuition and medical expenses from GST tax to such payments made by individuals, not distributions from trusts. In contrast with other proposals, the Greenbook proposes that this change would be effective when the bill proposing it is introduced and would apply both to trusts created after that date and to transfers after that date to pre-existing trusts.

Because of the lack of authority or consensus for their design, the use of HEETs is likely not as widespread as the use of installment sales or GRATs. But because of the abrupt effective date provision that is proposed, any contemplated HEETs should be completed promptly.

Also, because the proposal appears intended to repeal an exception for all generation-skipping trusts, not just trusts designed as HEETs, it might be thought that the creation and funding of all such trusts should be placed on a rush basis. Many of us do not recommend that because we expect that the reach of this proposal will be recognized as overbroad, and, if it is enacted, it will be in a more limited form. Even if it might be enacted as proposed, we believe that the care needed in designing all the features of a long-term trust, not just provisions for tuition or medical expenses, ordinarily should not be compromised.

Other Technical Estate Tax Changes. The Greenbook carries forward other proposals made in past years, including a requirement for consistency between estate tax values and income tax basis, an expiration of GST exemption allocations after 90 years, and an extension of liens when payment of the estate tax on closely held business interests is deferred.

Income Tax Proposals. There are again income tax proposals in the 2015 Greenbook that could significantly affect individual taxpayers. For example, so-called "stretch IRAs" inherited by beneficiaries other than the original owner's spouse would be limited to a term of five years. A controversial proposal would limit the total amount that could be accumulated in a tax-free retirement arrangement to an amount calculated with reference to the maximum annual benefit from defined benefit plans, currently about $3.2 million at age 62. Original owners of Roth IRAs would be required to take distributions from Roth IRAs after attaining age 70 ½ in the same way as owners of traditional IRAs. For individuals in the 33, 35, and 39.6 percent income tax brackets, the effect of certain exclusions and deductions would be limited to the effect they would have had in the 28 percent bracket. And the "Buffett Rule" would be implemented by a new minimum tax, called a "Fair Share Tax," ensuring a tax of at least 30 percent of adjusted gross income less a 28 percent credit for charitable contributions.

Unlike the technical estate tax proposals, these proposals are likely to move forward, if at all, in the context of a broad and intense debate about tax reform, the distribution of tax burdens, and the appropriate "balance" between spending and taxation.

3. 2014-2015 Priority Guidance Plan (August 26, 2014)

IRS issues Priority Guidance Plan

The 2014-2015 Priority Guidance Plan contains 317 projects (down only slightly from 324 last year, but identical to the 317 in the 2012-2013 Plan) described as "priorities for allocation of the resources of our offices during the twelve-month period from July 2014 through June 2015 (the plan year). The plan represents projects we intend to work on actively during the plan year and does not place any deadline on completion of projects."

The Plan contains the following 10 items under the heading of "Gifts and Estates and Trusts":

- Amendment to extend the effective date of final regulations under Section 67 regarding miscellaneous itemized deductions of a trust or estate. Final regulations were published on May 9, 2014. Published July 17, 2014, as T.D. 9664.
- Final regulations under Section 1014 regarding uniform basis of charitable remainder trusts. Proposed regulations were published on January 17, 2014.
- Revenue Procedure under Section 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability.
- Final regulations under Sections 2010 and 2505 regarding portability of the deceased spousal unused exclusion. Proposed and temporary regulations were published on June 18, 2012.
- Final regulations under Section 2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.
- Guidance under Section 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
- Regulations under Section 2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP.
- Final regulations under Section 2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.
- Regulations under Section 2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.
- Guidance under Section 2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

Most of these items have been carried over from past years. In fact, the average length of time that these 10 items have been on the Priority Guidance Plan is about 5¼ years.

4. Foreign Account Tax Compliance Act (FATCA)

FATCA takes effect in 2014

The Foreign Account Tax Compliance Act ("FATCA") took effect in 2014. FATCA was enacted as part of the Hiring Incentives to Restore Employment Act ("HIRE" Act) (Public Law

111-147), signed into law on March 18, 2010. It is codified in Sections 1471 through 1474 of the Internal Revenue Code of 1986, as amended ("the Code"). Its purpose is to combat tax evasion by taxpayers with undisclosed foreign financial accounts and other offshore assets, by requiring reporting with respect to those accounts and assets by both U.S. taxpayers and foreign financial institutions, and backing up that requirement by a 30 percent withholding obligation at the source of the income.

Proposed regulations were published on February 15, 2012 (77 FED. REG. 9022), numerous public comments were received, a public hearing was held on May 15, 2012, and final regulations were promulgated by T.D. 9610 on January 29, 2013. Withholding on some U.S.-source income payable to foreign financial institutions took effect on July 1, 2014.

Meanwhile, the worldwide commitment to the transparency FATCA encouraged has been strong. According to Announcement 2014-38, 2014-51 I.R.B. 951, as of July 1, 2014, 101 foreign jurisdictions had substantially committed to one of the two model intergovernmental agreements ("IGAs") the Treasury Department had promulgated in 2012.

5. Revenue Procedure 2014-61, 2014-47 IRB 860 (October 30, 2014)

IRS provides the 2015 inflation adjusted amounts for tax exemptions, deductions, brackets, and other items

This Revenue Procedure provides the 2015 inflation adjusted item amounts for tax exemptions, deductions, brackets and other tax items. Selected adjusted income and gift and estate tax numbers are:

- The gift tax annual exclusion remains at $14,000.
- The estate tax applicable exclusion amount is increased because of the inflation adjustment to $5,430,000.
- For an estate of a decedent dying in 2015, the aggregate decrease in the value of qualified property for which a special use valuation election is made under Section 2032 cannot exceed $1,100,000.
- The annual exclusion for gifts to non-citizen spouses is increased to $147,000.
- Recipients of gifts from certain foreign persons must report these gifts if the aggregate value of the gifts received in 2015 exceeds $15,601.
- For estates making the Section 6166 election to defer estate tax on closely held businesses and pay the tax in installments, the dollar amount used to determine the "2 percent portion"(for purposes of calculating the interest owed) is $1,470,000.
- The top 39.6% income tax rate hits at the following amounts for the different categories of taxpayers.

Married Individuals Filing Jointly	$464,850
Heads of Households	$439,000
Unmarried Individuals	$413,200
Married Individuals Filing Separately	$232,425
Estate and Trusts	$12,300

- The "Kiddie Tax" exemption increases to $1,050.

6. Letter Ruling 201406004 (Issued October 25, 2013; released February 7, 2014)

IRS grants an estate an extension of time to make the portability election

Decedent died survived by spouse. Decedent's estate was less than the basic exclusion amount in the year of decedent's death and decedent made no taxable gifts during decedent's lifetime. Decedent's estate did not file a Form 706 to make the portability election. The estate discovered its failure to make the portability election after the due date for the federal estate tax return.

The estate requested an extension of time under the provisions of Treas. Reg. § 301.9100-3. The IRS granted the extension of time since it appeared that the taxpayer acted reasonably and in good faith and that granting relief would not prejudice the interest of the government.

It noted that if it was later determined that decedent's estate had been required to file an estate tax return because the assets equaled or were greater than the applicable exclusion amount, the IRS was without authority under Treas. Reg. § 301.9100-3 to grant decedent's estate an extension of time to elect portability and the grant of the extension would be null and void.

Revenue Procedure 2014-18 (January 27, 2014) now provides an automatic extension of time for estates of decedents dying before January 1, 2014 with assets under the filing requirement to make the portability election.

7. Revenue Procedure 2014-18 (January 27, 2014)

Portability election made easier for estates of decedents who died before 2014, but executors of decedents who die in 2014 or later are still subject to stricter time limits

On January 27, 2014, the Internal Revenue Service published Revenue Procedure 2014-18, providing a simplified method to obtain an extension of time to make the "portability" election for estate and gift tax purposes with respect to the estate of a decedent who died in 2011, 2012, or 2013 survived by a spouse.

Portability of the unified credit was first enacted for two years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, effective January 1, 2011, and then was made permanent by the American Taxpayer Relief Act of 2012. When a decedent dying on or after January 1, 2011, is survived by a spouse, the amount of the unified credit available to that decedent's estate for estate tax purposes that is not used by that decedent's estate is "portable" – that is, it can be used for gift or estate tax purposes by the surviving spouse.

Although the unified credit is the actual mechanism provided by the Internal Revenue Code and operates to directly reduce the amount of estate tax (or gift tax), the available unified credit is initially calculated each year as the amount of gross tax that would be owed if the taxable estate were equal to the "basic exclusion amount," which itself is indexed for inflation each year after 2011. The "basic exclusion amount" is thus similar to an exemption, and it is often referred to as an "exemption." Any unified credit that the decedent used to reduce or eliminate gift tax paid on

taxable gifts during life reduces the amount available for estate tax purposes, which is what gives the credit its “unified” character.

Examples:

(1) If a decedent who has never made taxable gifts dies in 2014 when the basic exclusion amount is $5,340,000 and leaves nothing to anyone except that decedent’s surviving spouse, then the marital deduction eliminates the taxable estate, no unified credit is used, and the entire unified credit is “portable” to the surviving spouse. The effect is to increase the surviving spouse’s total exclusion amount, called the “applicable exclusion amount,” by that $5,340,000.

(2) If the decedent had made taxable gifts of $1,500,000 and at death left $600,000 to children, then the applicable exclusion amount available to that decedent’s estate would be $3,840,000 ($5,340,000-$1,500,000) and the unused amount portable to the surviving spouse would be $3,240,000 ($3,840,000-$600,000).

The statute (Section 2010(c)) refers to the $5,340,000 in (1) and the $3,240,000 in (2) as the “deceased spousal unused exclusion amount.” Regulations published in June 2012 abbreviate it to the “DSUE amount.”

Due Date of the Portability Election

The statute allows the DSUE amount to be made available to the surviving spouse only if the predeceased spouse’s executor elects portability on a federal estate tax return. Specifically, Section 2010(c)(5)(A) states:

> A deceased spousal unused exclusion amount may not be taken into account by a surviving spouse … unless the executor of the estate of the deceased spouse files an estate tax return on which such amount is computed and makes an election on such return that such amount may be so taken into account. Such election, once made, shall be irrevocable. No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return.

The normal time prescribed for filing a federal estate tax return is nine months after the date of the decedent’s death, although the executor may claim an automatic extension of six months, making the extended due date 15 months after the date of the decedent’s death.

Under Section 6018 of the Internal Revenue Code, an estate tax return is not required unless the decedent’s gross estate exceeds the basic exclusion amount (reduced by the amount of taxable gifts since September 9, 1976). But even if no estate tax return is required for estate tax purposes, an estate tax return may still be filed solely to elect portability, and under Section 2010(c)(5)(A) (quoted above) that is the only way portability can be elected. Thus, for an estate that is smaller than the filing requirement, it might be said that the return is not “prescribed” (required) to comply with the estate tax law, but it is “prescribed” if a portability election is desired. Before the regulations were published in June 2012, some reasoned that if a return is not required for estate tax purposes then no time is “prescribed” for its filing, and a return may be filed solely to

make the portability election at any time, perhaps even after the surviving spouse has died and it is determined that a portability election would have been useful. The June 2012 regulations (Treas. Reg. §20.2010-2T(a)(1)) rejected that argument and stated that the due date for filing an estate tax return solely to elect portability is the same as the due date of a return required for estate tax purposes.

Treas. Reg. §301.9100-3 grants the Internal Revenue Service broad discretion to grant extensions of due dates prescribed by regulations (often referred to as "9100 relief"), but not due dates prescribed by statute. The Service has interpreted this 9100 relief as available for portability elections because the due date is prescribed by the June 2012 regulations.

Revenue Procedure 2014-18, noting that this relief has been granted in several letter rulings, provides a simplified method to obtain an extension of time to make a portability election in the case of decedents' executors who are not required to file an estate tax return for estate tax purposes and who in fact did not file an estate tax return, ***but only in the case of predeceased spouses who died in 2011, 2012, or 2013***. The simplified method to obtain that extension is to simply file the otherwise late estate tax return, ***on or before December 31, 2014***, and state at the top of the return "FILED PURSUANT TO REVENUE PROCEDURE 2014-18 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)." The return must then be prepared in accordance with Treas. Reg. §20.2010-2T(a)(7). Under Section 2203 of the Internal Revenue Code and Treas. Reg. §20.2010-2T(a)(6)(ii), if no executor or administrator of the predeceased spouse's estate is appointed – for example, by a probate court – an "executor" for purposes of electing portability can be "any person in actual or constructive possession of any property of the decedent."

Executors of decedents who died in 2011, 2012, and 2013 survived by a spouse may now elect portability if no estate tax return was needed or was filed, but only by acting under Revenue Procedure 2014-18 before the end of 2014. This will save those executors the expense and uncertainty of a ruling request for 9100 relief. Such executors who have already filed ruling requests for 9100 relief may receive a refund of their user fee if they notify the Service before March 10, 2014 (or, if earlier, before the ruling is issued) that they will rely on Revenue Procedure 2014-18 and withdraw their ruling request.

If the surviving spouse has died and an estate tax return was filed without the benefit of portability, the surviving spouse's executor may file a protective claim for any refund that portability would justify, but such claims might be due as early as October 1, 2014 and Revenue Procedure 2014-18 provides no relief from that due date. Portability provides for the use of a DSUE amount, however, only if *both* spouses died on or after January 1, 2011.

Executors who can benefit from Revenue Procedure 2014-18 include executors of decedents with same-sex spouses to whom they were legally married. Those executors could not have known that portability would be available for same-sex married couples until the Supreme Court decided United States v. Windsor, 570 U.S. ___, (2013), on June 26, 2013 and the Service issued Revenue Ruling 2013-17, 2013-38 I.R.B. 201, on August 29, 2013. Revenue Procedure 2014-18 provides relief for those executors who were not required to file an estate tax return, while Revenue Ruling 2013-17 itself provides relief if an estate tax return was filed without electing or using portability.

The relief provided by Revenue Ruling 2014-18, however, applies to all married persons who died in 2011, 2012, and 2013 for whom an estate tax return was not required, not just to same-sex married couples.

Revenue Procedure 2014-18 provides no relief with respect to decedents who die in 2014 or later. The executors of such decedents have until at least October 1, 2014, to file estate tax returns (or claim automatic extensions) and make the portability election. If they fail to do so, Revenue Procedure 2014-18 confirms that they may continue to seek 9100 relief through a ruling request under Treas. Reg. §301.9100-3.

The Treasury-IRS Priority Guidance Plan for the 12-month period beginning July 1, 2013, includes a new guidance project described as "Revenue Procedure under Section 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability." That is not Revenue Procedure 2014-18. It is expected that this new guidance project will update the applicability of Revenue Procedure 2001-38, 2001-24 I.R.B. 1335, which announced circumstances in which the IRS "will disregard [a QTIP] election and treat it as null and void" if "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." The QTIP election will always be unnecessary to reduce estate tax liability on an estate tax return not even required for estate tax purposes but filed solely to elect portability, but QTIP elections on such returns are explicitly contemplated by the June 2012 regulations (Treas. Reg. §20.2010-2T(a)(7)(ii)(A)(*4*)). The tension between those two pronouncements is what this new item on the Priority Guidance Plan will evidently address.

8. Letter Ruling 201442015 (Issued July 15, 2014; released October 17, 2014)

IRS concludes that an estate was not entitled to an extension to make a carryover basis election for a 2010 decedent because the executor failed to act in good faith

After decedent's death in 2010, the executor retained a law firm to assist in the administration of the estate and an accounting firm to prepare the Form 8939 to opt out of the estate tax and elect carryover basis. The executor signed the form 8939 in the accounting firm's office prior to the January 17, 2012 due date. The accounting firm made copies of the signed Form 8939 for its file and for the executor. The accounting firm then mailed the original Form 8939 to the IRS Service Center by regular mail. The accounting firm had a longstanding practice to use regular mail for all tax returns that showed little or no tax due. The accounting firm failed to advise the executor that there were alternative methods of mailing the Form 8939 which would have ensured timely filing.

The IRS notified the executor that the IRS had no record of having received a Form 706 from the decedent. As a result of correspondence with respect to this, it was determined that, while a Form 706 was not needed, the IRS had not received a copy of the Form 8939. The law firm then notified the IRS that it believed that the accounting firm had filed the Form 8939. The IRS requested the law firm for a copy of the Form 8939 and the law firm indicated that it would obtain a copy. In the interim, the IRS examiner contacted the Service Center for a copy of the Form 8939 and the Service Center responded that it had never received a copy. Eventually, the

accounting firm provided the IRS with a copy of the Form 8939 and affidavits explaining its long-standing practice of transmitting return with little or no tax due by regular mail to show that the Form 8939 was timely mailed.

The executor was unable to provide proof that the Form 8939 was timely mailed either by registered or certified mail or other designated delivery service as required by Section 7502. The executor then requested an extension of time pursuant to Treas. Reg. § 301.9100-3 to file the Form 8939 to make the section 1022 election for carryover basis treatment as a result of decedent's death in 2010.

The IRS denied the request. It noted that Treas. Reg. § 301.9100-3 permits the granting of extension of time when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. Here, the executor was unable to provide direct proof of actual delivery or proof that the Form 8939 was sent to the IRS by either registered or certified mail or other designated delivery service. Instead, the executor maintained only that the postal service lost the filing. Thus, the executor failed to present prima facie evidence under Section 7502 that the Form 8939 was delivered to the IRS.

The Service also rejected the executor's assertion that he relied on qualified tax professionals and that the tax professionals failed to inform the executor of mailing methods that would have ensured timely filing. According to the Service, the failure of the accounting firm to advise the executor that there were methods other than regular mail for timely filing the Form 8939 did not meet the standards of reasonableness and good faith necessary for granting the relief. The Service also noted that the Executor did not provide the Service with a copy of the allegedly filed Form 8939 until several months after the date that the Service was notified that the estate had opted out of the estate tax.

MARITAL DEDUCTION

9. Letter Ruling 201410011 (Issued November 9, 2013; released March 7, 2014)

Spouse's right to elect under revocable trust is not a "contingency" which disqualifies a gift for the estate tax marital deduction and the marital deduction will be allowed for the distribution of preferred units in limited liability company to a QTIP marital deduction trust

Under an antenuptial agreement, taxpayer and spouse each waived their respective rights of election to take against the will or other dispositive instrument. Pursuant to the antenuptial agreement, if spouse survived taxpayer, spouse was to receive an outright gift. In addition, if the marriage lasted at least ten years, then, upon his death, taxpayer was to fund a QTIP marital trust with a specified percentage of his taxable estate.

Taxpayer established a revocable trust that was amended and restated several times. One provision of the revocable trust provided that the spouse could take under the terms of the antenuptial agreement and that the trustee could satisfy any distribution to the marital trust under the antenuptial agreement with LLC preferred units. An alternative section provided that if the spouse made an election within 180 days following taxpayer's death to receive the "elective

marital portion" in lieu of any distributions under the antenuptial agreement, the trustee would distribute one sum to spouse outright and property interests to the marital trust. The elective marital portion marital trust would still be funded with preferred units in the LLC. Taxpayer also established a marital trust that would become irrevocable at his death and qualify as a QTIP trust. The QTIP trust provided that the net income was to be distributed to the surviving spouse at least quarter-annually. No distributions of principal could be made. Several provisions were included so that the marital trust would qualify for the estate tax marital deduction including the right of the spouse to make any unproductive or underproductive assets productive. The trustee was also prohibited from exercising any powers that would disqualify the trust for the estate tax marital deduction.

The LLC's primary asset was an interest in a limited partnership engaged in the ownership, management, development and financing of shopping centers. Under the operating agreement, the preferred members had a right to payments of 8 percent annually before any other distributions to other members were made.

The first issue addressed by the IRS was whether the spouse's right to make an election to take under the antenuptial agreement or to take the elective marital share was a contingency that would disqualify the gift for the estate tax marital deduction. The IRS relied upon Revenue Ruling 54-446, 1954-2 C.B. 303; Revenue Ruling 68-271, 1968-1 C.B. 409; Estate of Tompkins v. Commissioner, 68 T.C. 912, acq. 1982-1 C.B. 1; and Revenue Ruling 82-184, 1982-2 C.B. 215 to determine that amounts passing to a spouse pursuant to an election to choose between different options would not be a disqualification for the marital deduction. For example, in Revenue Ruling 82-184, the decedent bequeathed a life income interest in a trust to a spouse and granted the spouse an election to take an outright bequest of $50,000 in lieu of the life income interest. This IRS held that a cash bequest in lieu of a life estate payable unconditionally at the election of the surviving spouse would qualify for the estate tax marital deduction.

In this Letter Ruling, the IRS noted the spouse would either receive certain property interests under the terms of the antenuptial agreement or the elective marital portion. In each event, the spouse would have an absolute right to any property passing outright to her as well as an absolute right to income from any property passing to the marital trust which would qualify the marital trust for the estate tax marital deduction if a QTIP election was made. Thus, there was no contingency.

The IRS also found that the marital trust met the requirements for a QTIP trust. This was because the testator's intention that, after his death, the marital trust should produce for the spouse during life that degree of the beneficial enjoyment of the LLC preferred units with which the trust funded was clear.

10. Letter Ruling 201406003 (Issued September 13, 2013; released February 2, 2014)

IRS concludes that trustee is entitled to an extension of time to notify the IRS that decedent's spouse, who is the beneficiary of a qualified domestic trust, has become a United States citizen

Decedent died intestate survived by his spouse. At the time of decedent's death, spouse was not a United States citizen and consequently established a qualified domestic trust meeting the requirements of Section 2056A. Spouse also executed an irremovable assignment of assets to the qualified domestic trust. Spouse, as executrix of decedent's estate, filed the federal estate tax return and elected to treat the trust as a qualified domestic trust on Schedule M. Subsequently spouse became a United States citizen.

Spouse then died. The spouse had resided in the United States since the time of decedent's death until her death and no distributions had been made to spouse other than distributions of income.

The trustee of the qualified domestic trust was not advised that spouse had become a U.S. citizen and did not file the necessary Form 706 QDT during the required time period. Upon learning that the spouse had become a U.S. citizen, the trustee submitted this request.

Notice that a spouse has become a U.S. citizen is to be made by filing a final Form 706 QDT on or before April 15 of the calendar year following the year in which the surviving spouse becomes a U.S. citizen. Here the trustee requested relief under Treas. Reg. § 301.9100-3. The IRS determined that the taxpayer acted reasonably and in good faith and granted an extension of time for the final form to be filed certifying that spouse had become a U.S. citizen. This would allow the assets to be taxed in spouse's estate and to be sheltered, perhaps, from tax by spouse's applicable exclusion amount.

11. Letter Ruling 201421006 (Issued February 11, 2014; released May 23, 2014)

IRS grants extension of time to allow trustee to amend trust to meet the requirements for qualified domestic trusts

Decedent, who was a United States citizen, died and was survived by a spouse who was not a United States citizen. Decedent created a marital trust to be held for the benefit of spouse during her life. The trust contained a provision permitting the trustee to amend or reform the terms of the trust to allow the trust to qualify as a qualified domestic trust, so that the trust would qualify for the marital deduction.

The executor timely filed an estate tax return which included the election of the executor to treat the trust as a qualified domestic trust. The executor now sought an extension of time to amend the trust to meet certain requirements for a qualified domestic trust. These included that the trust have at least one acting U.S. trustee that was a bank and to provide that no principal distributions would be made without the approval of the corporate trustee which was serving as the U.S. trustee.

The IRS found that the request for an extension of time to make the amendment met the requirements in Treas. Reg. § 301.9100-3, which permits an extension of time to make an election whose due date is prescribed by regulation if the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. The IRS concluded that these requirements had been satisfied.

12. Letter Ruling 201431019 (Issued April 10, 2014; released August 1, 2014)

Extension of time to file notice that spouse has become a United States citizen granted

Decedent's spouse was not a United States citizen at the time of decedent's death. As a result, a portion of decedent's estate was distributed to a qualified domestic trust. The executor made the election to treat the trust as a qualified domestic trust and claimed an estate tax marital deduction for the property transferred to that trust.

Subsequently, the spouse became a United States citizen. The corporate trustee requested advice from an accountant and was not informed that the trustee must file the final Form 706-QTD by April 15 of the year after the spouse obtained citizenship in order for the trust to escape treatment as a qualified domestic trust. After discovering the requirement, the trustee requested an extension of time pursuant to Treas. Reg. § 301.9100-3. A request for relief under Treas. Reg. § 301.9100-3 will be granted when a taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a tax professional. The IRS found that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and an extension of time was granted to file the final Form 706-QTD.

13. Letter Ruling 201431004 (Issued April 16, 2014; released August 1, 2014)

Extension of time to file notice that spouse has become a United States citizen granted

Decedent's spouse was not a United States citizen at the time of decedent's death and qualified domestic trust was created for the benefit of spouse. The executors made the election to treat the trust as a qualified domestic trust. The initial co-trustees of the trust were the spouse, an attorney, and the son of the decedent. The attorney resigned at a subsequent date, at which time the daughter of the decedent became a successor co-trustee with the spouse and son.

Subsequently, the spouse became a citizen of the United States. None of the son, daughter, or spouse were aware of the need to file a final Form 706-QTD in order to avoid application of the estate tax imposed on distributions from a qualified domestic trust. In addition, although a tax professional was retained to prepare the tax returns and the spouse retained an attorney for estate planning services, the co-trustees were never informed of the need to file a final Form 706-QTD. After the spouse's death, the co-trustees were informed of the necessity to file a Form 706-QTD by an attorney hired by the son to assist in administering the trust after the death of the spouse.

Treas. Reg. § 301.9100-3 provides that a request for an extension of time will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a tax professional to make the election. The Service determined in this letter ruling that the requirements of Treas. Reg. § 301.9100-3 had been satisfied.

14. CCA 201416007 (April 18, 2014)

No marital deduction permitted to extent that elective share is to be satisfied with assets in a trust in a foreign country held for the benefit of child

Decedent created an irrevocable trust which was administered in a foreign country. The trust was to be governed by the laws of that country and administered by the courts of that country. A corporate fiduciary situated in the foreign country was designated as trustee. The decedent and his adult child were the only beneficiaries. The trust included shares of stock of companies situated in the foreign country in which the trust was created and stock of companies in other foreign countries. None of the trustee or any company whose shares were held in the trust were subject to the jurisdiction or laws of the United States or any state.

Decedent died survived by spouse. Spouse took her elective share. In computing the elective share, the property held in the foreign trust was included. The law of the applicable state provided a tier system for satisfying the elective share. The elective share was first funded with assets otherwise passing to the spouse, next, assets in the decedent's probate estate and revocable trusts, and, finally, with assets in irrevocable trusts. On the federal estate tax return, the estate took a marital deduction for the entire amount of the elective share. There was a shortfall in what the spouse could actually receive because the elective share could not be fully satisfied from the first and second tiers, and so property in the irrevocable foreign trust was counted as qualifying for the marital deduction even though the property in the irrevocable foreign trust could not be distributed to the spouse.

The Chief Counsel opined that the shortfall would not qualify for the marital deduction because the assets in the trust did not pass to the surviving spouse at the decedent's death. In order to qualify for the estate tax marital deduction, assets must pass to the surviving spouse from the deceased spouse. The Chief Counsel based its opinion on the Tax Court's decision in Estate of Turner v. Commissioner, 138 T.C. 306 (2012) (Turner II). Turner II addressed the issue of whether a surviving spouse's interest pursuant to bequest in a decedent's will is considered as having passed to the spouse when the spouse is not the beneficial owner of the property available to satisfy the request. In the opinion in Estate of Turner v. Commissioner, T.C. Memo. 2011-209 (Turner I), the Tax Court found that partnership interests that the decedent transferred during the decedent's life to family members were includable in the decedent's gross estate under Section 2036. In Turner II, the estate argued that under the formula marital deduction clause of the decedent's will, the spouse was to receive an amount of property equal in value to the amount necessary to result in the smallest amount, if any, of federal estate tax. The Tax Court noted that because family limited partnership interests had been transferred during life to other family members, those interests were not considered as passing to the surviving spouse and therefore would not be entitled to the marital deduction under the marital formula. Using the same logic,

the Chief Counsel found that the assets included in the irrevocable trust located in a foreign county for the benefit of the child could not be considered as passing to the spouse and therefore would not qualify for the federal estate tax marital deduction.

15. Estate of Olsen, T.C. Memo 2014-58

IRS holds that assets in a QTIP Trust should be included in the estate of the surviving spouse

Wife died in 1998. Under her estate plan, a credit shelter trust and two marital trusts were funded. $1 million went to Marital Trust A, $505,000 went to Marital Trust B, and $600,000 to a Family Trust. A QTIP election was made for Marital Trust A and Marital Trust B on the federal estate tax return for Wife. Husband was named as trustee of the three trusts.

After Wife's death, Husband failed to fund the three separate and distinct trusts. Subsequently, Husband withdrew funds totaling $1,475,000, including a charitable contribution to a college, a second charitable contribution to a college, and a withdrawal that was deposited into one of his personal accounts. Husband died on February 25, 2008. One of Husband's sons acted as executor and trustee. Son then created the three separate and distinct trusts. He funded the Family Trust with all of the assets that remained after the two charitable contributions and the transfer to Husband's personal account. Son argued that the previous withdrawals had used up the assets that otherwise would have funded the two marital trusts. The IRS argued that no assets remained in the Family Trust at Husband's death since those assets were used in making the charitable gifts and the remaining assets should be treated as QTIP trust assets subject to estate tax in Husband's estate.

The court essentially split the difference. The court stated that the two withdrawals totaling $1,080,000 for the charitable gifts should be treated as having been made from the Family Trust and that the $394,000 withdrawal that was deposited in Husband's personal account should be treated as being made from the marital trusts. This was because the Family Trust gave Husband a special lifetime power of appointment to appoint principal to one or more charities, and the Family Trust was the only trust from which Husband could have made a gift to charity. Additionally, with respect to the marital trusts, principal could be paid to husband for health, education, support and maintenance which would permit the withdrawal by Husband for his personal use. The court ordered that the estate should include approximately $608,000 which was the value of the marital trusts on the applicable alternate valuation date after being reduced by the $394,000 withdrawal from the marital trusts.

16. Letter Ruling 201426016 (Issued March 11, 2014; released June 27, 2014)

Division of QTIP Marital Deduction Trust into three separate trusts will create three separate QTIP Trusts; termination of third trust will not cause spouse to be deemed to have made a gift of the property in the other two trusts and no gain or loss would be recognized; termination of third trust will not cause first two trusts to fail to qualify as QTIP Trusts at Decedent's death

A QTIP marital deduction trust was created for the benefit of spouse. Under the QTIP marital trust, Spouse was to receive the income for life and discretionary principal for her accustomed standard of living and for her health, medical, dental, hospital, nursing, and invalidism expenses. Upon Spouse's death, she was given a limited testamentary power of appointment to descendants. In default of the exercise of the limited power of appointment to descendants, a portion of the assets passed to Decedent's children and the balance passed to two other individuals.

The trustees proposed to divide the martial trust into three separate trusts: Trust 1, Trust 2, and Trust 3. Following the division, the Trustees intended to convert Trust 2 to a total return unitrust with an annual unitrust payment equal to not less than three percent or more than five percent of the fair market value of the assets of trust to be determined annually. The trustees also proposed to petition a court to terminate Trust 3 and distribute the assets of Trust 3 equally to Decedent's children. Decedent's children planned to reimburse Spouse for any and all gift taxes incurred as a result of the termination of Trust 3.

The IRS first ruled that each of Trust 1, Trust 2, and Trust 3, after the initial division of the Marital Trust, would continue to be QTIP Trusts under Section 2056(d)(7).

The Service next ruled that the division of the Marital Trust into three separate QTIP Trusts would not be a deemed gift since the Spouse would retain her qualifying income interest in all three trusts.

The Service then held that the termination of Trust 3 would result in Spouse making a gift of her income interest under Section 2511 and of the remainder interest under Section 2519. The Service also indicated that this would be a net gift with the amount of the gift from Spouse to Decedent's children being reduced by the amount of gift taxes paid by Decedent's children. The termination of Trust 3 would also not cause Spouse to be deemed to have made a gift of any property in Trust 1 or Trust 2.

The Service then held that converting Trust 2 to a private unitrust would not cause Spouse to be deemed to make a gift to the remainder beneficiaries or vice versa since the conversion would meet the requirements of Treas. Reg. § 1.643(b)-1. Spouse's Trust 2 would meet the income requirement since Spouse was entitled to the income as determined under local law because of a reasonable allocation by the trustee between the income and remainder beneficiaries of the total return of the trust.

The Service then ruled that termination of Trust 3 would not result in Spouse making a deemed gift under Section 2519 with respect to either Trust 1 or Trust 2. In addition, any assets previously held in Trust 3 would escape estate taxation at Spouse's death.

Finally, the distribution of assets from the Marital Trust to the new trusts with the approval of the state court on a prorated basis would not cause the interests of the beneficiaries in the three separate trusts to differ materially from their interest under the Marital Trust. As a result, the distribution of the assets would not cause the Marital Trust to recognize gain or loss.

GIFTS

17. <u>Estate of Davidson v. Commissioner</u>, T.C. Docket No. 13748-3

IRS challenges self-cancelling installment note

In December 2008 and January 2009, William M. Davidson, the former owner of the Detroit Pistons and the president, chairman, CEO, and owner of 78 percent of the common stock of Guardian Industries Corp., one of the world's largest manufacturers of glass, automotive, and building products, was engaging in transactions of his own, including gifts, substitutions, a five-year GRAT, and sales that, like Mrs. Kite's, eventually paid him no consideration at all. He was 86, and his actuarial life expectancy was about five years. He lived for 50 days after making the last transfer and died on March 13, 2009.

The consideration for some of Mr. Davidson's sales included five-year balloon unconditional notes at the applicable federal rate, five-year balloon self-canceling installment notes ("SCINs") at the section 7520 rate with an 88 percent principal premium, and five-year balloon SCINs at the section 7520 rate with a 13.43 percent interest rate premium. Addressing Mr. Davidson's sales both in Chief Counsel Advice 201330033 (Feb. 24, 2012) and in its answer in the Tax Court, the IRS believed the notes should be valued, not under section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson's health. Even though four medical consultants, two chosen by the executors and two chosen by the IRS, all agreed on the basis of Mr. Davidson's medical records that he had had at least a 50 percent probability of living at least a year in January 2009, the IRS saw the notes as significantly overvalued because of his health, and the difference as a gift. Combined gift and estate tax deficiencies, with some acknowledged double counting, are about $2.6 billion.

The Davidson Estate filed its Tax Court petition on June 14, 2013 (Docket No 13748-13), and the IRS filed its answer on August 9. Trial was set by the court for April 14, 2014, but the parties jointly moved to continue it. In an Order on December 4, 2013, that motion was granted, jurisdiction was retained by Judge David Gustafson, and the parties were ordered to file joint status reports on September 14, 2014, and every three months thereafter. If the case is not settled, Judge Gustafson's opinion will be interesting.

18. **Estate of Donald Woelbing v. Commissioner (Tax Court Docket No. 30261-13, petition filed Dec. 26, 2013) and Estate of Marion Woelbing v. Commissioner (Tax Court Docket No. 30260-13, petition filed Dec. 26, 2013); Estate of Jack Williams v. Commissioner (Tax Court Docket No. 29735-13, petition filed Dec. 19, 2013)**

Sweeping IRS Attacks on time-honored techniques

Woelbing. In these two docketed cases widely discussed in 2014, the Tax Court has been asked to consider a sale by Donald Woelbing, who owned the majority of the voting and nonvoting stock of Carma Laboratories, Inc., of Franklin, Wisconsin, the maker of Carmex skin care products.

According to the Tax Court petitions, Mr. Woelbing sold all of his Carma nonvoting stock in 2006 to a grantor trust in exchange for an interest-bearing promissory note in the amount of $59 million, the fair market value of the stock determined by independent appraiser. The installment sale agreement provided that if the value of a share of stock were determined to be higher or lower than that set forth in the appraisal, whether by the Internal Revenue Service or a court, then the number of shares of stock purchased would automatically adjust so that the fair market value of the stock purchased equaled the amount of the note. The trust's financial capability to repay the promissory note without using the stock itself or its proceeds exceeded 10 percent of the face value of the promissory note, including three life insurance policies on Mr. and Mrs. Woelbing's lives that were the subject of a split-dollar insurance arrangement with the company. The policies had an aggregate cash value of about $12.6 million, which could be pledged as collateral for a loan or directly accessed through a policy loan or the surrender of paid-up additions to the policies. At the time of the sale transaction, two sons of the Woelbings executed personal guarantees in the amount of 10 percent of the purchase price.

Mr. Woelbing died in 2009, and the IRS challenged the 2006 sale in connection with its audit of his estate tax return. The IRS basically ignored the note, doubled the value of the stock at the time of the gift to $117 million, again increased the value of the stock at the time of Mr. Woelbing's death to $162 million and included that value in his gross estate, and asserted gift and estate tax negligence and substantial underpayment penalties. For gift tax purposes, the notices of deficiency asserted that the entire value of the stock was a gift at the time of the sale, either because section 2702 applied to ignore the note or because the note in fact had no value anyway. For estate tax purposes, the IRS asserted that Mr. Woelbing retained for his life the possession or enjoyment of the stock or the right to designate the persons who shall possess or enjoy the stock under section 2036 and the right to alter, amend, revoke, or terminate the enjoyment of the stock under section 2038.

Thus, besides simple valuation, the Tax Court might be obliged to address the adjustment clause, the possible reliance on the life insurance policies and guarantees to provide "equity" in the trust to support the purchase, and the applications of section 2702 to the sale and sections 2036 and 2038 after the sale.

Williams. Similarly, in Williams the IRS challenged a partnership owning real estate and business and investment assets with a wide variety of arguments, including disregarding the

existence of the partnership and treating transfers to the partnership as a testamentary transaction at the decedent's death, undervaluation of the partnership assets, lack of a valid business purpose or economic substance for the partnership, the decedent's retained enjoyment of the partnership assets, restrictions on the right to use or sell the partnership interest ignored under section 2703(a), liquidation restrictions ignored under sections 2703, 2704(a), and 2704(b), and any lapse of voting or liquidation rights in the partnership treated as a transfer under section 2704(a).

Comment. The everything-but-the-kitchen-sink approach reflected in these late-2013 Tax Court petitions, especially the Woelbing petitions, has chilled transactions that had been commonplace in estate planning, including installment sales to grantor trusts. Recent Administration proposals for legislation to reduce the benefits of sales to grantor trusts, even though they may not gain traction in Congress, serve to reinforce the perception of increased animus toward these transactions.

This comes as IRS review of gift tax returns filed for 2012 is hitting top speed. Most of those gift tax returns will be entering the third year of the three-year statute of limitations in 2015. With the lifetime gift tax exemption of $5.12 million headed for a return to $1 million if Congress failed to act, we know that many of these 2012 gifts were large, leveraged, imaginative, often done in haste, often accompanied with some form of defined value provision, and sometimes edging close to the boundaries of the reciprocal trust doctrine in the case of married donors. The public discussions of the 2012 gift tax landscape were interesting. The gift structures and related transactions we heard discussed were interesting. The gift tax returns – nearly 370,000 of them according to IRS statistics– must *be* interesting – the last thing we want a tax return to be. It is very possible that 2015 will bring word of more aggressive audits and that 2016 will see Tax Court petitions for which the Woelbing and Williams petitions were just a warm-up.

19. Letter Rulings 201410001 - 201410010 (Issued October 21, 2013; released March 7, 2014)

IRS addresses gift and estate tax consequences of incomplete non-grantor trusts

This series of near identical rulings involves incomplete non-grantor trusts for the benefit of the grantor and the grantor's family. The issue was whether the grantor would be treated as the owner of the trusts for fiduciary income tax purposes (which would defeat the apparent purpose of providing a vehicle which would be a separate taxpayer for income tax purposes in a state without a state income tax and through which highly appreciated assets could be sold avoiding state income tax that the grantor would have to pay in the grantor's home state if the grantor owned the assets himself or herself).

Under the provisions of these trusts, the net income and principal of the trusts could be distributed to the grantor and beneficiaries as directed by the distribution committee and/or the grantor in a non-fiduciary capacity. The grantor retained the limited power to appoint the trust property by will at her death. The distribution committee was initially composed of the grantor, grantor's children (or appointed guardians acting on behalf of the children until the children reached the age of majority); and grantor's step-children. Each trust provided that at all times the distribution committee must include at least two members other than the grantor.

The rulings hold that the trusts revealed no circumstances that would cause the grantor to be treated as the owner of any portion of the trust for income tax purposes under Sections 673 (ownership of a reversionary interest in the corpus or income if the value of such reversionary interest exceeds 5 percent of the value of such portion), 674 (owner of any portion of the trust in respect of which the beneficial enjoyment of the corpus or the income is subject to a power of disposition exercisable by the grantor or a non-adverse party or both without the approval or consent of any adverse party), 676 (owner of any portion of the trust for which the grantor has a power to re-vest title in himself or herself) and 677(a) (owner of a trust pursuant to which the income may be distributed to or held for future distribution to the grantor or the grantor's spouse or applied to the payment of premiums of insurance on the life of the grantor or the grantor's spouse). The IRS also held that none of the other distribution committee members would be treated as the owner of any portion under Section 678(a) (person other than the grantor treated as the owner for income tax purposes of a trust if such person has a power exercisable solely by himself to vest corpus or income therefrom in himself or has released such a power). In addition, the letter rulings noted that circumstances attendant on the operation of the trust would determine whether the grantor would be treated as the owner of any portion of the trust under Section 675 (the grantor is treated as the owner if administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiary of the trust).

In addition, the contribution of property to the trust by the grantor would not be a completed gift for gift tax purposes because of the grantor's retained testamentary limited power of appointment. Any distribution of property from the trust to a beneficiary of each trust other than the grantor would be a completed gift by the grantor and upon the grantor's death, the fair market value of the trust property would be includable in the grantor's gross estate.

20. Letter Rulings 201430003 and 201430004 (Issued February 7, 2014; released July 25, 2014)

Service rules favorably on a form of incomplete non-grantor trust

These are two of the many rulings dealing with the income tax and gift tax consequences of incomplete non-grantor trusts. In these letter rulings, the grantor proposed to create an irrevocable trust for the benefit of himself, his issue, the issue of his children, and four individuals. The trustee was a corporate trustee. During the grantor's lifetime, the beneficiaries of the trust were the grantor and four adult individuals.

The trust provided that the trustee must make distributions of income and principal as directed either by the Distribution Committee or the grantor. The Distribution Committee had to consist of at least two members who were not beneficiaries of the trust.

At any time, the trustee pursuant to the direction of the majority of the members of the Distribution Committee, with the written consent of the grantor, would distribute income and principal to such one or more beneficiaries (the "Grantor's Consent Power").

At any time, the Distribution Committee, by unanimous vote of the members, could direct the distribution of income or principal to the beneficiaries (the "Unanimous Member Power").

Finally, the grantor, in a non-fiduciary capacity, could distribute to any one or more of the beneficiaries other than himself, his estate, or the creditors of either, principal as the grantor deemed advisable to provide for the health, education, maintenance, or support of the grantor's issue (the "Grantor's Sole Power").

At the grantor's death, the grantor was given a broad limited power of appointment (the "Broad Special Testamentary Power of Appointment"). To the extent that this limited power was not exercised, the trust was divided into equal parts. One half was to be distributed in equal shares to the four named beneficiaries who survived him. The other half was to be distributed to the grantor's children or their issue if a child did not survive.

The Service first ruled that so long as the Distribution Committee was serving, the trust would not be treated as a grantor trust for income tax purposes. The Service concluded that the trust contained none of the provisions that would cause the grantor or any other person to be treated as the owner of any portion of the trust under Sections 673, 674, 676, 677 or 678.

As for Section 675, the Service noted that while the trust revealed none of the circumstances that would cause administrative controls to be considered exercisable primarily for the benefit of the grantor or any other person under Section 675, the circumstances of the administration and operation of the trust would determine whether Grantor or any other person would be treated as the owner of any portion of the trust under Section 675. The Service noted that this was a question of fact, and a determination of this issue would be deferred until the income tax returns of the parties had been examined by the Service.

The Service next ruled that the contribution of property of the trust by the grantor would not be a gift for gift tax purposes. The retention by the grantor of the Grantor's Consent Power caused the transfer of the property to the trust to be incomplete. In addition, the retention of the Grantor's Sole Power caused the transfer to the trust to be wholly incomplete for gift tax purposes, since it gave the donor the power to change the interest of the beneficiaries. In addition, the grantor's Broad Special Testamentary Power of Appointment caused the gift to be incomplete with respect to the remainder in the trust for federal gift tax purposes.

The Service then concluded that any distribution of property by the Distribution Committee to any beneficiary other than the grantor would not be a completed gift subject to gift tax by any member of the Distribution Committee. However, any distribution of the property from the trust to a beneficiary other than the grantor would be a completed gift by the grantor.

21. Letter Rulings 201436008 (Issued December 27, 2013; released September 5, 2014) and 201436032 (Issued December 30, 2013; released September 5, 2014)

IRS rules on tax consequences of incomplete non-grantor trusts

These are two more rulings dealing with incomplete non-grantor trusts. In each of these letter rulings, the grantor proposed to create an irrevocable trust for the benefit of himself, parents, siblings, and issue. Two independent trustees would act as trustees. The trustee was required to

make distributions of income and principal as directed by the Distribution Committee and/or the grantor as follows:

1. Grantor's consent power. Distributions could be made pursuant to the direction of a majority of the Distribution Committee with the written consent of the grantor.

2. Unanimous member power. The Distribution Committee acting unanimously could distribute income and principal.

3. Grantor's sole power. The grantor in a non-fiduciary capacity could distribute principal to any one or more beneficiary's other than himself under an ascertainable standard.

The distribution committee was to consist of at least two adults other than the grantor. The IRS first determined that whether the grantor would be treated as the owner of any portion of the trust for fiduciary income tax purposes under Section 675 would depend upon the operation of the trust. A determination could only be made when the federal income tax returns of the parties were examined.

The IRS then concluded that the contribution of the property to the trust by the grantor was not a complete gift subject to gift tax. Any distribution from the trust to the grantor was merely a return of the grantor's property. Any distribution of property by the Distribution Committee from the trust to the grantor would not be a completed gift by any member of the Distribution Committee. Furthermore, the fair market value of the property would be subject to estate tax in the grantor's estate. The IRS then concluded that any distribution of property by the Distribution Committee from the trust to any beneficiary of the trust other than the grantor would not be a completed gift subject to federal gift tax by any members of the Distribution Committee. Instead, any distribution of property from the trust to a beneficiary would be a gift by the grantor.

22. Letter Rulings 201510001 – 201510008 (Issued October 10, 2014; released March 6, 2015)

Favorable rulings on incomplete non-grantor trusts

Each of these rulings involved a favorable ruling with respect to an incomplete non-grantor trust. In each ruling, the grantor created an irrevocable trust for the benefit of himself, his issue, his spouse, and three other individuals. The trust provided that during the grantor's lifetime, the co-trustees must distribute such amounts of net income and principal as directed by a power of appointment committee and/or the grantor himself. The co-trustees, pursuant to direction of the majority of the committee members, with the written consent of the grantor could make distributions under the "Grantor's Consent Power." The co-trustees pursuant to the unanimous consent of all the Power of Appointment committee members, other than the grantor, could direct distributions of net income or principal (the "Unanimous Consent Power"). The grantor had the sole power in a non-fiduciary capacity to appoint principal to any one or more of the beneficiaries for their health, maintenance, support, and education ("Grantor's Sole Power). Finally, the grantor retained a broad special power of appointment to appoint to any one other than the grantor, the grantor's estate, or the creditors of either ("Grantor's Testamentary Power of Appointment).

The IRS concluded that none of the provisions would cause the grantor or any other persons to be treated as the owner of the trust under Sections 673, 674, 676, 677, or 678. It noted, as in prior rulings, that the circumstances of the operation of the trust would determine whether the grantor or any other person would be treated as the owner of any portion of the trust under Section 675 related to administrative control of the trust.

The IRS then noted that the retention of the Grantor's Consent Power over the income and principal of the trust caused the transfer to be incomplete for gift tax purposes. The retention of the Grantor's Sole Power over the principal of the trust also caused the transfer to be incomplete for gift tax purposes. In addition, the Grantor's Testamentary Power of Appointment caused the transfer to be incomplete with respect to the remainder in the trust. The committee's Unanimous Consent Power did not cause the transfer to be complete for gift tax purposes.

Finally, the powers held by the committee members did not cause any of the members of the committee to have any taxable general powers of appointment.

23. Letter Ruling 201403005 (Issued September 19, 2013; released January 17, 2014)

Taxpayer's proposed disclaimers of contingent rights to interests in two irrevocable trusts will not be subject to gift tax

Donor created one trust under which the trustee could pay income or principal for the benefit of donor's child or the descendants of donor's child for illness, accident, other misfortune or any emergency, as well as for the beneficiaries' comfortable maintenance, support or education. The trust was an irrevocable trust created prior to January 1, 1977. Upon termination of the trust, which was to run for the common law perpetuities period, the trustee would distribute the property *per stirpes* to the descendants of the child.

Taxpayer was a child of the child, the grandchild of donor, and one of the beneficiaries to whom discretionary distributions of income and principal could be made from the first trust. Taxpayer would also be entitled, if taxpayer survived, to a distribution of part of the trust property upon its termination. Taxpayer had yet to reach the age of majority and wished to disclaim her contingent right to receive any distributions from the first trust.

The child had also created an irrevocable trust for the benefit of child, child's spouse, and child's descendants. Different one-quarter shares of the trust were for the benefit of different beneficiaries. Taxpayer was entitled to distributions of income from one of the one-quarter shares in the event certain needs arose and would be entitled to a distribution of a portion of the remainder upon the termination of the second trust. The taxpayer proposed to disclaim her contingent right to distributions from the second trust.

Because the interests were created before January 1, 1977, the disclaimant had to disclaim the interests within a reasonable time after taxpayer had knowledge of the existence of the transfers creating the interests to be disclaimed pursuant to Treas. Reg. § 25.2511-1(c). The time limitation for making the disclaimer does not begin to run until the disclaimant has obtained the age of majority and is no longer under legal disability to disclaim. Since in each of these cases,

taxpayer would execute the disclaimer within nine months after obtaining the age of majority, the proposed disclaimers would be considered to be timely made under the provisions of Treas. Reg. § 25.2511-1(c).

24. Letter Rulings 201435007 through 201435010 (Issued April 23, 2014; released August 29, 2014)

Life tenants and remaindermen of pre-October 9, 1990 trust will not be treated as making a taxable gift when a trust is modified

Prior to October 8, 1990 when Chapter 14 became effective, Husband, Wife, and five of their six children purchased Property 1 for fair market value. Wife purchased a life estate, Husband purchased a life estate following wife's death, and each of the five children purchased a remainder interest. Each party paid the actuarial value of their respective interests from their own resources and none of the five children used funds acquired from their parents to acquire the interest. Next, prior to the effective date of Chapter 14, a sixth child received an interest in the property when that sixth child reached the age of majority. Subsequently, the life tenants and the remaindermen acquired additional property referred to as Property 2.

After October 8, 1990, Property 1 was sold to an unrelated party and the proceeds were deposited in the Proceeds Trust. Under the terms of the Proceeds Trust, the Life Tenants were to receive all of the income. Upon the death of both life tenants, the trust was to terminate and the trust assets were to be paid to the remaindermen in accordance with their respective interests.

On September 30, 2004, the IRS issued a private letter ruling relating to the sale of Property 1 and the deposit of the proceeds in the Proceeds Trust. In that 2004 letter ruling, the Service ruled that the proceeds of the sale of Property 1 and the reinvestment of the proceeds would be treated as a transfer occurring prior to the effective date of Chapter 14. In addition, Property 2 would continue to be treated as property acquired pursuant to a transfer occurring prior to October 8, 1990.

The life tenants and the remaindermen proposed to modify the terms of the Proceeds Trust to appoint an independent trustee who under state law could make equitable adjustments between the principal and income of the Proceeds Trust or could release the power to adjust and convert the Proceeds Trust into a unitrust.

The life tenants and the remaindermen requested a ruling that they not be treated as making a taxable gift as a result of (i) agreeing to modify the provisions of the Proceeds Trust, (ii) the exercise by an independent trustee of the power to adjust, (iii) the exercise by an independent trustee of the power to release the power to adjust and convert the Proceeds Trust to a unitrust, and (iv) the failure on the part of the life tenants and the remaindermen to object to the conversion of the Proceeds Trust to unitrust. They requested a second ruling that the agreement to modify the provision of the Proceeds Trust would not cause Chapter 14 to subsequently apply to the Proceeds Trust.

The IRS held that the modification of the Proceeds Trust would not cause the life tenants and remaindermen to be treated as having made a taxable gift. In addition, the independent trustee's

authority to adjust between income and principal would not cause the life tenants or the remaindermen to be treated as having made a taxable gift. Nor would the independent trustee's authority convert the Proceeds Trust to a unitrust cause a taxable gift. In addition, Chapter 14 would not apply to the Proceeds Trust going forward.

25. Estate of Sanders, T.C. Memo 2014-100

Tax Court denies motion for summary judgment with respect to whether gifts were adequately disclosed thereby triggering the running of the limitations period for assessment of additional gift tax

Decedent's husband founded a farm supply company that became a large business in the Mid-South. Decedent owned stock in the company and made gifts of the company stock to family members each year from 1999 through 2008. Each year, Decedent filed gift tax returns to report the gifts. Decedent died on April 5, 2008. The IRS examined the gift tax returns and, in 2012, issued deficiency notices for federal gift tax for nine of the ten years at issue.

Decedent's estate reported the fair market value of the company shares at $3,696,570. The IRS increased the value of the adjusted taxable gifts reported by the estate by $3,248,613.

The estate filed a Motion for Partial Summary Judgment to challenge the IRS's attempt to increase the value of the adjusted taxable gifts reported on the gift tax returns on the grounds that the statute of limitation period for contesting the gift tax returns had run.

The Court first noted that it will only grant a Motion for Summary Judgment if it is shown that there is no genuine dispute as to any material fact and that it may render a decision as a matter of law. In this case, the estate had the burden of proving that there was no genuine dispute as to any material fact with the facts being reviewed in the light most favorable to the IRS.

Pursuant to Section 2001(f), the value of prior taxable gifts will be treated as finally determined if a gift is reported on a gift tax return and the IRS does not contest the value of the gift before the running of the statute of limitations. The value of a gift is treated as being shown on a gift tax return if the gift is disclosed in a manner that is adequate to apprise the IRS of the nature of the gift. In general, a gift will be considered adequately disclosed under Treas. Reg. § 301.6501(c)-1(f)(2)(iv) if the taxpayer provides a detailed description of the method used to determine the fair market value of the property transferred, including any financial data (for example, balance sheets, etc., with explanations of any adjustments) that were used in determining the value of the property.

In this case, the court found that there were genuine disputes between the estate and the IRS with respect to whether the gift tax returns adequately disclosed the nature of the stock and the basis of the value reported. The IRS also contended that the information provided on the gift tax returns failed to disclose the company's ownership of another closely-held entity, which the regulations require if that information is relevant and material in determining the value of the stock.

As a consequence, the estate's Motion for Partial Summary Judgment was denied.

26. I.L.M. 201442053 (October 17, 2014)

IRS concludes that the recapitalization of a limited liability company was a transfer from a donor to her two children under Chapter 14

Donor and her two sons, Child A and Child B, formed a limited liability company. Donor made the sole capital contribution to the company. Thereafter, donor gave membership interests to her sons and their children.

Under the operating agreement, each member's capital account is credited for the amount of the member's capital contributions. Profits and losses are then allocated to the member's capital account pro rata based on the member's ownership interest.

At a subsequent date when the donor, the two children, and the grandchildren each owned separate membership interests in the company, the company was recapitalized. In exchange for the agreement of the two children to manage the company, the operating agreement was amended to provide that going forward, all profits and loss, including all gain or loss attributable to the assets of the company, would be allocated equally to the two children. After the recapitalization, the sole equity interest of the donor and the grandchildren in the company was the right to distributions based on their capital account balances as they existed immediately prior to the recapitalization.

The Service determined that both before and after the recapitalization, the donor held an Applicable Retained Interest in the company under Section 2701. An Applicable Retained is an interest in a corporation, partnership, or trust that is valued at zero in determining the gift tax consequences of a transfer of interests in the same entity to a junior family member. In this memorandum, the donor's retained interest, which carried a right to distributions based upon existing capital account balances, was senior to the transferred interest which carried only a right to distributions based on future profit and gain. Donor received property in the form of the agreement of the two children to manage the company. As a result, the recapitalization was a transfer by donor for purposes of Section 2701.

The memorandum also contains a discussion of the appropriate way in which to determine the value of the gift using the subtraction method of valuation. If Section 2701 applies, the amount of a transferor's gift is determined by subtracting the value of any family-held Applicable Retained Interests and other non-transferred equity interests from the aggregate value of the family-held interests. Any Applicable Retained Interest, such as the right to receive dividends, is usually valued at zero.

27. Cavallaro v. Commissioner, T.C. Memo 2014-189

Tax Court holds that husband and wife are liable for gift tax following company merger

In 1979, Mr. and Mrs. Cavallaro started Knight Tool Company. Knight was a contract manufacturing company that made tools and machine parts. In 1982, Mr. Cavallaro and his eldest son developed an automated liquid dispensing machine they called CAM/ALOT. Subsequently, in 1987, Mr. and Mrs. Cavallaro's three sons incorporated Camelot Systems, Inc.

which was a business dedicated to the selling of the CAM/ALOT machines made by Knight. The two companies operated out of the same building, shared payroll and accounting services, and collaborated in the further development of the CAM/ALOT product line. Knight funded the operations of both companies and paid the salaries and overhead costs for both.

In 1994, Mr. and Mrs. Cavallaro sought estate planning advice from the accounting firm of Ernst & Young and the law firm of Hale & Dorr. The professionals advised Mr. and Mrs. Cavallaro that the value of CAM/ALOT Technology resided in Camelot (the sons' company) and not in Knight and that they should adjust their estate planning. Mr. and Mrs. Cavallaro and their three sons merged Knight and Camelot in 1995 and Camelot was the surviving entity. Part of the reason for the merger was to qualify for Conformite Europeenne, which means European conformity, so that the CAM/ALOT machines could be sold in Europe. In the 1995 merger, Mrs. Cavallaro received 20 shares, Mr. Cavallaro received 18 shares and 54 shares were distributed to the three sons. In valuing the company, Ernst & Young assumed that the pre-merger Camelot had owned the CAM/ALOT technology. According to the court, Camelot had not owned the CAM/ALOT technology. As a result, the appraiser overstated the relative value of Camelot and understated the relative value of Knight at the time of the merger.

In 1996, Camelot was sold for $57 million in cash with a contingent additional amount of up to $43 million in potential deferred payments based on future profits. No further payments were made after the 1996 sale. The three issues under review by the tax court were:

1. Whether the 19% interest received by Mr. and Mrs. Cavallaro in Camelot Systems, Inc. in exchange for their shares of Knight Tool Company in a tax free merger was full and adequate consideration or was it a gift?

2. Whether Mr. and Mrs. Cavallaro were liable for additions to tax under Section 6651(a)(1) for failure to file gift tax returns for 1995 or was the failure due to reasonable cause.

3. Whether there were underpayments of gift tax attributable to the gift tax valuation understatement for purposes of the accuracy related penalty or whether any portions of the underpayment were attributable to reasonable cause.

With the respect to the valuation issue, the Cavallaros offered two experts with respect to the value of the combined entity. One expert valued the entity between $70 and $75 million and opined that only $13 to $15 million of that value was attributable to Knight. A second appraiser valued the combined entity at $72,800,000.

The IRS retained its own appraiser. This appraiser assumed that Knight owned the CAM/ALOT technology. He valued the combined entities at approximately $64.5 million and found that 65% of that value or $41.9 million was Knight's portion.

In reaching its decision on the gift tax liability, the court noted that the 1995 merger transaction was notably lacking in arm's length character. It also discussed how the law firm in 1995 had tried to document the ownership of the CAM/ALOT Technology by the sons but that such documentation was insufficient. It also thought the accountants had been less than truthful in some of their testimony. It noted that the IRS had conceded during the litigation that the value of the combined entities was not greater than $64.5 million and that the value of the gift made in the

merger transaction was not greater than $29.6 million. As a result, the court concluded that Mr. and Mrs. Cavallaro made gifts totaling $29.6 million in 1995.

The court rejected the imposition of penalties for failure to file a gift tax return and accuracy related penalties. It found that in both instances, Mr. and Mrs. Cavallaro had been advised by an accountant or lawyers and that there was reasonable cause for the failure to file a gift tax return and failure to pay the appropriate amount of tax. It noted that Mr. and Mrs. Cavallaro relied on the judgment and advice of the professional advisors and that the CAM/ALOT technology had been owned by the sons' company since 1987 (and thus was not being transferred in 1995). The court went into great detail about Mr. and Mrs. Cavallaro's lack of formal education beyond high school and that they had built the business up themselves in documenting its finding of reasonable cause to avoid the penalties.

28. Letter Ruling 201442042 (Issued June 18, 2014; released October 17, 2014)

Modification of a trust to correct scrivener's errors will permit desired tax consequences for grantor retained annuity trust

An attorney prepared separate four-year and fifteen-year grantor retained annuity trusts ("GRATs") for a client. Under each of the two GRATs, at the end of the applicable annuity term, the property would pass to a Children's Trust for the benefit of the grantor's children. The Children's Trust was drafted as a revocable trust and permitted the grantor to revoke the trust at and to amend or modify the trust at any time.

Subsequently, an accountant was retained by the grantor to prepare the gift tax return to report the transfers to the GRATs. After reviewing the trust documents, the accountant contacted the grantor to express concerns about the retention by the grantor of the right to revoke the trust. The accountant also contacted the attorney who drafted the two GRATs, but the attorney insisted that his drafting of the Children's Trust was proper and noted that the accountant, not being an attorney, did not understand state law governing the trust.

Several years later, a financial planner who reviewed the GRATs concluded that the Children's Trust contained incorrect provisions. The financial planner retained a new attorney to review the trust to also confirm that, for the transfers to the two GRATs to be completed gifts as intended, the grantor should not have the power to revoke the Children's Trust. The second attorney was then retained to reform the Children's Trust under state law. The court allowed the trust to be reformed subject to the issuance by the Internal Revenue Service of a letter ruling stating that the Service would respect the court's retroactive reformation of the Children's Trust for gift tax purposes.

In seeking the ruling, the grantor, the first attorney who drafted the Children's Trust, the accountant, the financial planner, and the second attorney provided affidavits and sufficient evidence that the Service believed constituted clear and convincing evidence that the retention by the grantor of the power to revoke the Children's Trust did not conform to the grantor's intention at the time he created and funded the GRATs for the gifts to the two GRATs to be completed gifts. The Service concluded that state law would permit the reformation of a trust to conform

to the grantor's intention if that is proved by clear and convincing evidence that the grantor's intent as expressed in the trust instrument was affected by a mistake of fact or law. As a result, the IRS concluded that, as a result of the reformation, the gifts would be completed and that the distribution of the remainder interests in the GRATs to the Children's Trust would not cause the grantor to make an additional gift. Also, the reformation of the Children's Trust would not cause the assets of the Children's Trust to be included in the gross estate of the grantor if he died after the end of the annuity term of each trust. Finally, the reformation of the Children's Trust would not cause any current or future beneficiary of the trust to make a gift to any other current or future beneficiary of the trust.

ESTATE INCLUSION

29. Letter Rulings 201427010–20147015 (Issued February 24, 2014; released July 3, 2014)

Beneficiary's testamentary power of appointment is not a general power of appointment causing inclusion of the trust property in the beneficiary's gross estate

These six letter rulings looked at the effect of a court order construing a power of appointment held by a beneficiary of an irrevocable trust as a non-taxable limited power of appointment. In each of these rulings, a trust was set up for the primary benefit of a beneficiary. Under the terms of the trust, the trustee could make discretionary distributions of net income to the beneficiary and the beneficiary's issue. Any net income not distributed to the beneficiary or beneficiary's issue was to be accumulated and held for future distribution or added to principal. Upon the beneficiary's death, the beneficiary was given a special testamentary power of appointment to appoint to the issue of his parent. The takers in default of this power of appointment were beneficiary's issue, otherwise the issue of beneficiary's parent, otherwise the issue of beneficiary's uncle, otherwise charity. The beneficiary fell within the class of the issue of the beneficiary's parent. If the beneficiary could appoint to himself, then the beneficiary would have a taxable general power of appointment. Arguably, the beneficiary, since the beneficiary had only a testamentary power of appointment, could not appoint to himself.

To resolve the ambiguity in the trust, the trustee filed for a declaratory judgment. The state court issued an order declaring that the testamentary power granted to beneficiary to appoint property to one or more of the issue of parent did not include the power to appoint property to the beneficiary, the beneficiary's estate, the beneficiary's creditors, or the creditors of the beneficiary's estate. This caused the power to be a non-taxable limited power of appointment.

The IRS concluded that the order of the state court was consistent with applicable state law as the highest court of the state would apply it. Therefore, the power of appointment held by the beneficiary would not be considered a taxable testamentary general power of appointment.

30. Letter Rulings 201438010 through 201438013 (Issued May 2, 2014; released September 19, 2014)

Powers of appointment have neither adverse lifetime nor testamentary tax consequences

Grantor created an irrevocable trust that in turn created separate trusts for the benefit of each of grantor's four children. Each of the children's trusts had three initial trustees – an investment trustee, an administrative trustee, and a distribution trustee. Grantor was the initial investment trustee. Corporate Trustee, an unrelated trust company, was the administrative trustee. Prior to a specific date, an independent person, who was not a beneficiary or related or subordinate party, served as the sole distribution trustee. On or after that specific date, when the child reached age 30, the child could serve as the distribution trustee in conjunction with the independent distribution trustee. Subsequently, when the named beneficiary attained the age of 40, the beneficiary could serve as the sole distribution trustee. In addition, an Approval Committee, consisting of all four children, could review distributions of trust property. The distribution trustee held the following powers, subject to the consent of the Approval Committee.

1. Prior to the designated specific date, with unanimous consent of the Approval Committee, the independent trustee could amend the trust instrument and amend any designation filed by an office holder or declaration filed by beneficiary or invalidate the same.

2. The distribution trustee, with unanimous consent of the Approval Committee, could distribute trust property to or for the benefit of such one more persons or organizations.

3. The distribution trustee could direct the administrative trustee to pay income and principal to the child as the distribution trustee decided was advisable with the consent of the Approval Committee, and after providing for the child, could pay income and principal to any one or more of the child's descendants.

The Approval Committee had the following powers with respect to the children's trust. The Approval Committee by a majority vote could override the exercise by a primary beneficiary of a non-general power of appointment in favor of the primary beneficiary's surviving spouse. The Approval Committee by unanimous vote could override the exercise by the primary beneficiary a non-general power of appointment in favor of any entity or person other than the primary beneficiary's surviving spouse. The Approval Committee, by majority vote, could also change the provisions in default of the exercise of the testamentary power of appointment. The Approval Committee acting by a 50% vote (unless provided otherwise by majority vote) could minimize various powers following the occurrence of a termination event including limiting or eliminating distributions to the primary beneficiary, restricting or eliminating the beneficiary's special power of appointment, and deeming the primary beneficiary deceased for the purpose of acting as or appointing any office holder. The Approval Committee could also appoint property to or for the benefit of one or more of grantor's descendants and a charity.

The IRS was asked to rule on two issues:

1. While more than one of the grantor's children was acting on the Approval Committee, would any of the Committee's powers be considered a testamentary general power of appointment?

2. While more than one of the grantor's children was acting on the Approval Committee, would any of the Committee powers be considered a lifetime power of appointment?

With respect to the issue of the testamentary power of appointment, the IRS noted that because all four children as the members of the Approval Committee had interests that were adverse to the other members, then, while more than one of grantor's children were acting on the Approval Committee, none of the Committee's powers would be considered a general power of appointment under Section 2041 because the other children had a substantial adverse interest under Section 2041(b)(1)(C)(ii).

With respect to the lifetime power of appointment, using the same reasoning under Section 2514 as it used with respect to the testamentary power of appointment, the IRS concluded that while more than one of grantor's children were acting on the Approval Committee, none of the Committee's powers would be considered a lifetime general power of appointment. This is because the powers could only be exercised in conjunction with another person with a substantial adverse interest in the property.

31. Letter Ruling 201429009 (Issued March 18, 2014; released July 18, 2014)

Family trust not includable in gross estate of decedent except for value of the 5 by 5 power held by decedent

Decedent and spouse created a joint revocable trust. Spouse predeceased decedent. Decedent subsequently died. Under the provisions of the joint trust, each spouse, while alive, could revoke his or her separate share. Upon the spouse's death, the surviving spouse could amend any trust share over which the spouse had a general power of appointment. Decedent and spouse agreed that the trust estate would be held as tenants in common with each having an undivided one-half interest. All joint tenancy property transferred to the trust would be treated as tenancy in common property. Upon the death of the first spouse, a survivor's share trust and a family trust were to be created. The survivor's trust would consist of the surviving spouse's separate share. The family trust would consist of all other assets. The trustee of the family trust could distribute income and principal for health, education, maintenance, and support to the surviving spouse. The surviving spouse was also given a 5 by 5 non-cumulative power of withdrawal property from the family trust each year. Upon the first spouse's death, decedent became the sole trustee and beneficiary of the survivor's trust and the family trust.

Although each of the survivor's trust and the family trust should have been funded with a 50% interest as a tenant in common with respect to the property held in the trust, this was not done. Instead, a law firm and the accountant advised that the survivor's trust would not be funded and instead 100% of the trust assets would remain as the family trust. Consequently, decedent, as trustee, invested all of the assets together. Subsequently, decedent retained a new law firm

which determined that the survivor's trust and the family trust should have been administered separately. Corrective measures were immediately taken to properly allocate assets to the survivor's trust and the family trust.

The decedent's estate requested a ruling that the value of the family trust assets would not be includable in the estate of the decedent except for those assets subject to the non-cumulative 5 by 5 power.

The IRS held that the property in the family trust would not be subject to federal estate tax under Sections 2036, 2038, and 2031. The IRS relied upon Revenue Ruling 78-74, 1978-1 C.B. 287, in which a decedent was the beneficiary of a trust created by his father. The trust terminated upon the death of the decedent and all assets became payable to decedent's issue. Prior to his death, the decedent transferred stock to the trust. The Service concluded that since the value of the stock could be readily ascertained, the portion of the trust includable in the decedent's gross estate was equal to value of the stock at the time of the decedent's death. Similar results were reached in Estate of Kinney v. Commissioner, 39 T.C. 728 and Estate of Bell v. Commissioner, 66 T.C. 729. Kinney held that when property is transferred by several grantors to a trust and co-mingled and cannot be identified, a proportionate formula may be appropriate. If a specific property can be identified, the value of the specific property should be included in the gross estate. In Bell, the parties stipulated to the securities transferred to the trust other than by decedent.

As a result, the IRS concluded that the value of the assets of family trust were not includable in decedent's gross estate except to the extent of the value of the 5 by 5 power held by the decedent.

32. Letter Ruling 201436036 (Issued May 21, 2014; released September 5, 2014)

Power of appointment reformed by court order to be a non-general power will not constitute a general power of appointment for estate tax purposes

An irrevocable trust was created giving the beneficiary a testamentary power of appointment. The terms of the power of appointment did not specifically limit the beneficiary's exercise of the testamentary power of appointment to persons other than the beneficiary's estate, the beneficiary's creditors, or the creditors of beneficiary's estate. When the settlors learned that the trust agreement failed to conform to their intent to grant the beneficiary a limited power of appointment, the grantors filed a trust reformation action to ensure that the testamentary power of appointment was a limited power of appointment.

The IRS concluded that the power of appointment, as reformed by the court, would not constitute a general power of appointment and that the trust assets would escape inclusion in the beneficiary's gross estate. Furthermore, the reformation of the trust agreement was not an exercise or release of a general power of appointment which would constitute a taxable gift by the beneficiary. The IRS noted that the underlying state law allowed the judicial reformation of a trust upon proof that the language used in the instrument did not reflect the party’s original intention. In this case, documentation was submitted indicating that the drafting intention of the grantors was to give the beneficiary a limited power of appointment. The court's reformation to

correct a scrivener's error was consistent with applicable state law that would be applied by the highest court of the state. This fell within the doctrine in the Estate of Bosch, 387 U.S. 456 (1967) in which the court concluded that a decision of a state trial court on an underlying issue of state law should not be controlling when applied to a federal statute. Instead, the highest court of the state was the best authority on the underlying substantive rule of state law to be applied in a federal matter. If there is no decision by the highest court of the state, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state court's determination and to the relevant rulings of other courts of the state. The IRS felt that the lower court had interpreted state law correctly.

33. Letter Rulings 201446001 – 201446011 (Issued July 14, 2014; released November 14, 2014)

Service holds that power of appointment granted to grandchild in trust is not a taxable general power of appointment

In each of these letter rulings, a grandchild was the beneficiary of a trust created under grandparent's will. During the grandchild's life, the trustees could make discretionary distributions of net income and principal for the benefit of the grandchild and the grandchild's issue. Upon the death of the grandchild, the trustees of the trust were directed to pay over the principal and any accumulated or undistributed income "to such among [Settlor's] issue" as the grandchild should validly appoint in the grandchild's last will. Each of these letter rulings requested the Service to rule that the grandchild's testamentary power of appointment was not a general power of appointment and would not cause the value of the trust to be included in the grandchild's estate upon the grandchild's death.

The Service noted that the grandchild could appoint the principal and accumulated or undistributed income to a class consisting of the Settlor's issue. However, because the grandchild's power of appointment was a testamentary power, the grandchild could not appoint any part of the trust to the grandchild or the grandchild's creditors during the grandchild's life. In addition, in examining the terms of the trust, the reference to "such among [Settlor's] issue" as a permissible class of appointees of the testamentary power should be properly viewed as not including the grandchild's estate or the creditors of the grandchild's estate after the grandchild's death. Consequently, the testamentary power was not a general power of appointment that would have adverse estate tax consequences upon the grandchild's death.

VALUATION

34. Estate of Kessel v. Commissioner, T.C. Memo 2014-97

Tax Court concludes that Internal Revenue Service is not entitled to summary judgment with respect to the value of a personal pension plan that decedent had and which was invested with Bernard L. Madoff

Decedent owned Bernard Kessel, Inc. In 1982, Bernard Kessel, Inc. created a defined benefit plan in which decedent was the sole participant. In 1992, the plan invested $610,000 with Bernard Madoff Investments. Decedent designated his fiancée as the beneficiary of 70% of the death benefits and his son as the beneficiary of 30% of the death benefits.

Decedent died on July 16, 2006. Based on information provided by Madoff Investments, decedent's estate reported the value of the assets in the plan as $4,811,853. After decedent's death, the fiancée made seven withdrawals from the account, totaling $2.8 million. Bernard Madoff was arrested in late 2008. Decedent's plan subsequently tried to recover the $3,221,057 in securities positions reflected on the account statement for the month immediately before Madoff's arrest in late 2008. The Madoff bankruptcy trustee denied the plan's claim because Madoff Investments had not actually purchased securities for the account and the account had a positive net equity of $2,721,337. The estate submitted a supplemental estate tax return on which it reported the date of death value in the investment account as zero. The estate submitted a claim for a refund of the estate tax in the amount of $1,937,391.

The IRS denied the estate's request for a refund and determined that the value of decedent's taxable estate was greater than the amount reported by the estate. The estate then filed a petition with the Tax Court alleging, among other matters, that the fair market value of the Madoff account was zero.

The IRS then filed a motion for partial summary judgment requesting the court to find that (1) the Madoff account, as opposed to the purported holdings of the Madoff account, was the property subject to federal estate tax; and (2) a hypothetical buyer from a willing seller of the Madoff account would not reasonably have known or foreseen that Madoff was operating a Ponzi scheme at the time of decedent's death in 2006.

The court denied the IRS's motion for partial summary judgment on both issues. With respect to the first issue, the court agreed that the Madoff account existed on the date of decedent's death. It disagreed with the IRS's argument that the Madoff account must be the property valued for federal estate tax purposes. It noted that the creation of legal interests in property is generally governed by state law, while federal tax law determines what interests so created shall be taxed. It appeared that the owner of the Madoff account had what appeared to be property-like rights in the agreement with Madoff Investments concerning the Madoff account. However, the court could not say whether that agreement constituted a property interest includable in decedent's gross estate separate from or exclusive of any interest decedent had in the purported assets in the Madoff account. That question would have to be answered at trial.

The court also rejected the IRS's argument that a hypothetical willing buyer and willing seller of the Madoff account would not have reasonably known or foreseen that Madoff was operating a Ponzi scheme when decedent died in 2006. It noted that later-occurring events are relevant in determining fair market value only if they were reasonably foreseeable at the time of transfer. Estate of Gilford v. Commissioner, 88 T.C. 38 (1987). It also noted that later occurring events not affecting value may be relevant to the determination of fair market value regardless of their foreseeability at the time of transfer. Estate of Jung v. Commissioner, 101 T.C. 412 (1993).

The IRS argued that a Ponzi scheme, by its very nature, is not reasonably knowable or foreseeable until discovery or collapse. For purposes of the summary judgment motion, the court disagreed because some individuals had suspected years before Mr. Madoff's arrest that his record of consistently high returns was simply too good to be true. Whether a hypothetical willing buyer and willing seller would have access to information and to what degree this information would have affected the fair market value of the Madoff account or the assets

purportedly held in the Madoff account on the date of the decedent's death were disputed material facts and consequently summary judgment had to be denied on this issue.

35. Riegels v. Commissioner (In re Estate of Saunders), 745 F.3d 953 (9th Cir. 2014)

Ninth Circuit upholds disallowance of an estate's deduction for a contingent claim for which the estimated value on the date of death was not reasonably ascertainable, but allows the deduction of the subsequent settlement amount

The Estate of Gertrude Saunders claimed a $30 million deduction on its estate tax return under Section 2053 for the possible amount that the estate would have to pay because of a lawsuit pending at the time of her death even though the suit was ultimately settled for a smaller sum. The Tax Court upheld the commissioner's disallowance of the $30 million deduction for the estimated value of the claim, but allowed a deduction for the actual settlement amount of $250,000. This case involved the value of a legal malpractice claim brought against Gertrude Saunders' spouse, William Saunders, by Harry S. Stonehill. Stonehill's estate alleged that William Saunders provided damaging information about Stonehill to the Internal Revenue Service, which exposed Stonehill to considerable tax liability. Stonehill's estate sought to recover damages of at least $90 million. In a jury trial on the Stonehill claim, the jury determined that Saunders had breached his duties to Stonehill but concluded that Saunders' misconduct did not cause any damages to Stonehill or his estate. During an appeal of this case, the parties settled with Gertrude Saunders' estate having to pay $250,000.

The court noted that the opinions of the experts used by the estate varied widely. One valued the potential liability under the Stonehill claim at $30 million at the time of William Saunders' death, but acknowledged that an adverse judgment in the Stonehill claim could result in a liability ranging between $1 and $90 million. At a subsequent date, this appraiser revised his valuation down to $25 million. A second appraiser determined that the value of the claim was $19.3 million. A third appraiser determined the claim was worth $22.5 million. The IRS's appraiser valued the claim between $3 million and $7.5 million.

The Ninth Circuit looked at this case through the framework of its earlier decision in Marshall Naify Revocable Trust v. United States, 672 F.3d 620 (9th Cir. 2012), which also involved the deductibility of a contingent claim. It noted that the wide disparity of the valuations given by the estate's expert was a "prima facie indication of the lack of reasonable certainty". In addition, under Treas. Reg. § 20.2053-1(b)(3), an estate cannot deduct a claim based on a vague or uncertain estimate. Because the estimated value of the claim was not ascertainable with a reasonable certainty, the Circuit Court found that the Tax Court properly disallowed the estate's $30 million deduction, but correctly allowed the deduction in the amount paid to settle the claim after decedent's death.

This case arose before October 20, 2009, when the Internal Revenue Service issued final regulations under Section 2053 to provide guidance in determining the deductible amount of a claim against a decedent's estate under Section 2053 and thus is of limited value in addressing the valuation of claims. The final regulations provided that, with certain exceptions, the amount deducted for a Section 2053 claim or expense is limited to the amount actually paid in settlement

or satisfaction of that claim or expense. For amounts that were not paid or otherwise deducted at the time that the estate tax return was filed, Treas. Reg. § 20.2053-1(d)(5)(i) permits the filing of a protective claim for refund.

The regulation provides in part that a protective refund claim may be filed at any time before the expiration of the Section 6511(a) period of limitations in order to preserve the estate's right to claim a refund in the case of a claim or expense that might not be paid or might not otherwise meet the requirements for deductibility under Section 2053 until after the expiration of the period of limitations for filing the claim for refund. Section 6511(a) provides that a claim for refund must be filed within three years after the time that the return was filed or two years from the time the estate tax was paid. If no return was filed by the taxpayer, the claim must be filed within two years from the time that any of the tax was paid.

The protective claim for refund should identify and describe in detail the claim or expense for which a Section 2053 deduction is claimed. It must be accompanied by documentary evidence, including certified copies of the letters of testamentary, letters of administration, or other evidence to establish the legal authority of the fiduciary or other person to file and pursue the protective claim for refund. Beginning January 1, 2012, a protective claim for refund may be filed by attaching a Schedule PC to the estate's Form 706 at the time of filing that return. The Form 706 should indicate that one or more Schedule PCs are being filed with the return in order to facilitate the proper processing of the Schedule PCs.

If the Form 706 was previously filed, a protective claim for refund may be filed by filing a Form 843 with the notation "Protective Claim for Refund under Section 2053" entered across the top of page one of the form and sent to the Cincinnati campus of the IRS. A separate protective claim for refund must be filed for each claim or expense for which a deduction may be claimed in the future under Section 2053.

Revenue Procedure 2011-48, 2011-42 I.R.B. 527 (October 17, 2011) contains several rules with respect to the identification of a claim or expense. In general, the Service must be given sufficient notice of each claim or expense. With respect to contested matters, identification of a claim that is being litigated may be satisfied by attaching a copy of the relevant pleadings.

One interesting provision of the revenue ruling is that although a Section 2053 protective claim for refund will be timely filed even if the Service fails to acknowledge its receipt and/or process the protective claim, the fiduciary or other person filing the form on behalf of the estate is directed to promptly contact the Internal Revenue Service to inquire into the Service's receipt and processing of the protective claim for refund if the estate fails to receive written acknowledgment or a receipt within 180 days of filing a Section 2053 protective claim for refund on a Schedule PC attached to the Form 706 or within 60 days within filing a Section 2053 protective claim for refund on a Form 843. A certified mail receipt or other evidence of the delivery to the Internal Revenue Service is insufficient to ensure and confirm the Service's receipt and processing of the protective claim for purposes of the revenue procedure.

36. Estate of Richmond v. Commissioner, T.C. Memo 2014-26

Tax Court determines value of decedent's interest in a family-owned personal holding company using a net asset value method and imposes a 20 percent accuracy-related penalty for substantial undervaluation on estate tax return

Helen Richmond died on December 10, 2005. At the time of her death, she owned a 23.44% interest (consisting of 548 shares) in the Pearson Holding Company. Pearson Holding Company was a family owned investment company incorporated in 1928 as a subchapter C corporation. On the date of Helen Richmond's death, the shares were held by 25 family members whose interests ranged from 0.17% to 23.61%. The three largest shareholders (which included Helen Richmond) owned 59.20% of the shares.

Pearson Holding Company had a portfolio of marketable securities with a total value of $52.1 million and a stated investment philosophy of maximizing dividend income. Because of a slow turnover in securities that it held, Pearson Holding Company had a built-in capital gain tax liability of 87.5% of the value of its portfolio.

As the owner of less than a majority of Pearson Holding Company's stock, Helen Richmond could not unilaterally change the management or investment philosophy of the company, could not unilaterally gain access to corporate books, could not increase distributions from the company, and could not cause the company to redeem her stock. She had no rights to force the company to buy her shares and the company could not demand to buy her shares.

The two executors hired an accounting firm to prepare the federal estate tax return and to value the Pearson Holding Company stock. The accountant who prepared the valuation was a CPA and certified financial planner, but did not have any appraiser certifications. The accountant used a capitalization of dividends method that valued Helen Richmond's interest in Pearson Holding Company at $3.1 million. The accountant provided an unsigned draft of the valuation report to the executors and the return preparer, but was never asked to finalize the report. The estate, without any additional consultation with the accountant, reported the value of Helen Richmond's interest in Pearson Holding Company at $3.1 million on the federal estate tax return.

The Internal Revenue Service (IRS) on audit increased decedent's interest in Pearson Holding Company to $9.2 million and imposed a 40% gross valuation estate penalty of $1.1 million. At trial, the IRS's expert, John A. Thomson, using the stipulated net asset value of $52.1 million, calculated Helen Richmond's interest to be worth $7.3 million, after applying a 6% minority interest discount and a 36% discount to account for the lack of marketability and for the built-in capital gain tax. The estate offered Robert Schweihs as its expert. He determined that the estate's interest was worth $5.0 million, using a capitalization of dividends method. Schweihs also valued the decedent's interest in Pearson Holding Company using the net asset value method and determined a value of $4.7 million. Schweihs applied an 8% discount for lack of control, as compared to Thomson's 6% discount and a 35.6% discount for lack of marketability (as compared to Thomson's 21%). Schweihs also used a dollar for dollar reduction to adjust for the built-in capital gains tax.

The Tax Court determined that the fair market value of Helen Richmond's interest was $6.5 million. This was based upon a 15% reduction in net asset value to account for the built-in capital gains tax, a 7.75% discount for lack of control, and a 32.1% discount for lack of marketability. The court first determined that the net asset value method should be used. It stated that the capitalization of dividends valuation is based entirely on estimates about the future, such as the future of the general economy, the future performance of the holding company, and future dividend payouts by the holding company. Instead, in the court's opinion, the focus for valuation should be on the most concrete and reliable data, which was the actual market prices of the publicly traded securities in Pearson Holding Company's portfolio. It noted that the courts are overwhelming inclined to use net asset value for valuing holding companies whose assets are marketable securities, citing Estate of Litchfield v. Commissioner, T.C. Memo. 2009-21; Estate of Smith v. Commissioner, T.C. Memo. 1999-368; Estate of Ford v. Commissioner, T.C. Memo. 1993-580, aff'd. 53 F.3d 924 (8th Cir. 1995); and Rev. Rul. 59-60, 1959-1 C. B. 243.

The Tax Court did not accept the opinion of the expert that the value of the holding company should be discounted by 100% of the $18.1 million built-in capital gains tax liability. In doing so, it rejected the opinions in Estate of Jelke v. Commissioner, 507 F.3d 1317 (11th Cir 2007.); Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002), and Estate of Jameson v. Commissioner, 267 F.3d 366 (5th Cir. 2001). The court, based on Estate of Jensen v. Commissioner, T.C. Memo. 2010-182 and Estate of Litchfield v. Commissioner, T.C. Memo. 2009-21, said that the best way to determine the impact of the built-in capital gains tax liability was to determine the present value of the cost of paying off that liability in the future. In this case, it rejected the IRS's approach of using the historic rate of turnover. For Pearson Holding Company, the turnover period would be 70 years. Instead, the court looked at using a 20- to 30-year holding period and found that a $7.8-million built-in capital gains tax discount was reasonable. The court then determined that a 7.75% minority discount was appropriate as was a marketability discount of 32.1% discount, which was within the general range of marketability discounts relevant for consideration in this case of 26.4 to 35.6%. The court's analysis resulted in a $6.5 million value for decedent's 23.44% interest in the holding company.

The court also imposed a 20% accuracy related penalty under Section 6662(a). This was because the amount reported on the estate tax return was less than 65% of the proper value. It also determined that the estate had lacked reasonable cause for its valuation and that the estate had not acted in good faith with respect to its valuation. Instead it noted that one of the co-executors was a CPA and the other co-executor had attended business school and had modest experience in financial matters. They had hired a CPA who, while having some appraisal experience, did not have any appraisal certifications. Moreover, the estate did not act with reasonable cause and in good faith because it used an unsigned draft report prepared by its accountant as the basis for reporting the value of the interest in the company.

37. Elkins v. Commissioner, 767 F.3d 443 (5th Cir. 2014)

Fifth Circuit reverses Tax Court and allows estate tax discounts for fractional interests in artwork

The Tax Court decided Estate of Elkins v. Commissioner on March 11, 2013. On September 15, 2014, the Court of Appeals for the Fifth Circuit technically affirmed in part and reversed in part, but largely reversed.

The case involved a family that co-owned valuable artwork subject to a cotenancy agreement that required unanimous consent to sell any of the artwork and waived each cotenant's unilateral right to partition.

James A. Elkins and his wife each owned a 50% interest in 64 works of modern and contemporary art as community property which they purchased during their life. Elkins and his wife each created an inter vivos grantor retained income trust ("GRIT") that held title to their respective one-half interests in three of the 64 works. After the death of his wife during the term of the GRITs and for the remainder of his lifetime, Elkins received and continued to own wife's 50% interest in those three pieces. His three children received an equal share of Elkins' 50% interest or 16.667% each when Elkins' interest in the GRIT terminated. At his wife's death, his wife left her 50% interest in the 61 remaining art works to Elkins. Elkins disclaimed a 26.945% interest in each to take full advantage of wife's applicable exclusion amount. As a result, Elkins owned at his death an aggregate 73.055% interest in each of those 61 pieces, comprising his original 50% interest and the 23.055% interest from his wife's bequest that remained after deducting the interest disclaimed by Elkins. The disclaimed interest in the 61 works of art passed equally to the three children and was owned by them at Elkins' death.

On the decedent's estate tax return, the executors claimed a 44.75 percent discount reflecting the lack of marketability under the cotenancy agreement, and the time and expense of a partition action even if the agreement were unenforceable. In the Tax Court litigation, the estate claimed a valuation discount of nearly 67 percent, based on the views of art experts that no one would want a partial interest in the art without a very substantial discount.

The Tax Court (Judge Halpern) held that Section 2703(a)(2) required that the restrictions on partitioning in the cotenancy agreement be disregarded. The executors had argued that the cotenancy agreement restricted the sale of each item of art, but did not restrict the sale of fractional interests owned by the cotenants, and thus should not be subject to section 2703(a). The court concluded that the cotenancy agreement had the effect of waiving the right of partition, and as such was a restriction "on the right to sell or use … property" within the meaning of section 2703(a)(2). Nevertheless, the court rejected the IRS assertion that there should be no discount and held that a 10 percent discount was available to reflect the lessened marketability of a tenancy-in-common interest in art. But it viewed the discounts claimed by the executors as unrealistically high because it viewed it as "false or at least highly dubious" that the Elkins children would endure such economic loss just to stand by the cotenancy agreement.

The Court of Appeals for the Fifth Circuit reversed and rendered, ordering a refund of $14.4 million plus interest. It agreed with the Tax Court's rejection of the IRS's "*no* discount" position

and emphasized that the IRS offered *no* evidence of the proper amount of discount if any discount is allowed. With regard to the estate's evidence of discounts at trial, larger than the discounts on the estate tax return, the court stated that "[w]e repeat for emphasis that the Estate's uncontradicted, unimpeached, and eminently credible evidence in support of its proffered fractional-ownership discounts is not just a 'preponderance' of such evidence; it is the *only* such evidence." The court repudiated the Tax Court's assumption about the Elkins children, stating:

> It is principally within the last few pages of its opinion that the Tax Court's reversible error lies. While continuing to advocate the willing buyer/willing seller test that controls this case, the Tax Court inexplicably veers off course, focusing almost exclusively on its perception of the role of "the Elkins children" as owners of the remaining fractional interests in the works of art and giving short shrift to the time and expense that a successful willing buyer would face in litigating the restraints on alienation and possession and otherwise outwaiting those particular co-owners. Moreover the Elkins heirs are neither *hypothetical* willing buyers nor *hypothetical* willing sellers, any more than the Estate is deemed to be the hypothetical willing seller.

In a footnote, the court suggested that it was not concerned with the fact that the estate tax return had employed a smaller discount, because "the IRS disallowed that discount." It did not mention section 2703.

In this rather harsh opinion toward the Tax Court, the Fifth Circuit noted that its review left it with the "definite and firm conviction" that the Tax Court had made a mistake. As a result, it did not remand the case to the Tax Court but entered a final judgment accepting the discounts originally offered by the estate and permitting a refund of taxes overpaid in the amount of $14,359,508.21.

38. Giustina v. Commissioner, Unpublished Opinion (9th Cir. 2014)

Ninth Circuit reverses decision of Tax Court in valuation case in which the issue was the amount of the discount for a minority interest in a limited partnership

The estate of Natale Giustina held a 41.128% interest in Giustina Land and Timber Company Limited Partnership. On the federal estate tax return the limited partnership interest was valued at $12,678,117. The Tax Court determined that the interest was worth $27,454,115. In its determination of the valuation, the Tax Court concluded that there was a 25% likelihood of a liquidation of the partnership. It therefore gave a 25% weight to an asset based valuation and a 75% weight to the valuation of the partnership as a going concern. The Tax Court recognized that the owner of the limited interest could not unilaterally force liquidation, but it concluded that the owner of that interest could form a two-thirds voting block with other limited partners to do so and assigned a 25% probability to this occurrence. The Ninth Circuit stated that this conclusion was contrary to the evidence in the record. It noted that in order for a liquidation to occur, a court must assume that a hypothetical buyer would somehow obtain admission as a limited partner from the general partners who repeatedly emphasized the importance that they placed upon continued operation of the partnership. The buyer would then turn around and seek dissolution of the partnership or removal of the general partners who just approve the buyer's

admission to the partnership. The buyer would then manage to convince at least two of the limited partners to go along, despite the fact that no limited partner ever asked or ever discussed the sale of an interest. As an alternative, the existing limited partners, who owned two-thirds of the partnership, would seek dissolution.

Quoting from Estate of Simplot v. Commissioner, 249 F.3d 1191 (9th Cir. 2001), the Ninth Circuit stated that the Tax Court in this case, as in Simplot, engaged in "imaginary scenarios" as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with the existing partners.

The estate had also claimed that the Tax Court erred by using pre-tax cash flows for the going concern portion of the valuation. The Ninth Circuit noted that it could not say that the Tax Court clearly erred adopting a pre-tax rather than a post-tax methodology since this was an unsettled matter of law. In addition, the Tax Court did not clearly err by using the IRS's 25% marketability discount rather than the estate's 35% discount, especially since the estate's expert acknowledged that such discounts typically range between 25% and 35%.

The Ninth Circuit then held that the Tax Court clearly erred by failing to adequately explain its basis for cutting in half the company's specific risk premium offered by the estate's valuation expert. It noted that the Tax Court is obligated to detail its reasoning. The Ninth Circuit recognized that diversification of assets is a widely excepted mechanism for reducing a company's specific risk. It noted that the Tax Court stated only that "investors can eliminate such risks by holding a diversified portfolio of assets" without considering the wealth the potential buyer would need in order to adequately mitigate risk through diversification.

As a result, the decision of the Tax Court was reversed and remanded for recalculation of the valuation.

This is the second recent case in which a circuit court has reversed a decision of the Tax Court with respect to valuation. The first was Estate of Elkins v. Commissioner, 767 F.3d 443 (5th Cir. 2014), which involved the valuation of a fractional interest in artwork owned by a decedent and his children and in which the Fifth Circuit severely chastised the approach taken by the Tax Court in permitting only a 10% valuation discount and not the 44.75% discount claimed by the estate.

CHARITABLE GIFTS

39. Gust Kalapodis v. Commissioner, T.C. Memo 2014-205

Tax Court concludes that taxpayers are not entitled to an income tax charitable contribution deduction for scholarship payments made by irrevocable trust created in memory of deceased son

In 2006, Mr. and Mrs. Kalapodis received $75,000 in life insurance proceeds as a result of the death of their son. That same year, the Kalapodises used the life insurance proceeds to establish a memorial scholarship fund in honor of their son. The scholarship fund was structured as an irrevocable trust. The trust agreement stated that the income from the trust is to be used

exclusively for educational purposes. The trust did not apply for tax-exempt status as a charitable organization. During 2008, the trust made payments of $2000 each to three high school students. Each payment was made by check directly to the student from an account owned solely in the name of the trust.

When the Kalapodises filed their 2008 individual income tax return, they did not include the investment income from the trust in their gross income; however, they claimed a $6,000 charitable income tax deduction for the payments made to the students. The IRS disallowed the charitable income tax deduction claimed by the Kalapodises.

The Tax Court held that the Kalapodises were not entitled to the $6,000 income tax charitable contribution for three reasons. First, an irrevocable trust and not the Kalapodises paid the money out as scholarships. No provision of the trust agreement would permit the Kalapodises to report the tax attributes of the trust on their personal income tax return. Second, even if the Kalapodises could report the tax attributes of the irrevocable trust on their personal return, the trust payments did not qualify as charitable contributions. Section 170(c) has specific rules for who are permissible recipients of a contribution or a gift in order for the payment to qualify as a charitable contribution for which an income tax charitable deduction is permitted. Students did not fall into any of the permissible categories of recipients. Finally, the Kalapodises failed to produce any evidence of a contemporaneous written acknowledgement of the charitable contribution since the amount was over $250 as required by Section 170(f)(8)(A).

40. Whitehouse Hotel Ltd. Partnership v. Commissioner, 755 F.3d. 236 (5th Cir. 2014)

Court of Appeals affirms Tax Court's ruling disallowing a significant portion of a tax deduction for historic conservation easement but permits the use of the good faith exception to prevent imposition of a 40% gross overstatement penalty

Whitehouse was formed in 1995 to purchase the Maison Blanche building in New Orleans and then renovate and reopen it as a Ritz-Carlton hotel and condominium complex with retail space. On December 29, 1997, Whitehouse conveyed a conservation easement to the Preservation Alliance of New Orleans. The easement involved maintaining the appearance of the ornate terra cotta façade of the building. On its 1997 tax return, Whitehouse claimed a $7.445 million income tax charitable deduction for the easement.

In 2003, the IRS allowed a charitable income tax deduction of only $1.15 million for the easement and assessed a gross valuation penalty of 40% of the underpayment of tax. Whitehouse challenged the valuation of the easement and the gross valuation penalty in the Tax Court in 2008. The government's appraiser and the Whitehouse's appraiser did not agree on what property was to be valued. Whitehouse's appraiser included an adjacent building because it was to be brought under common ownership the day after the creation of the easement. The appraisers disagreed over the highest and best use of the Maison Blanche building. Whitehouse's appraiser used three methods, the replacement cost, income, and comparable sales methods, to determine a $10 million value of the easement. The government's appraiser used only the comparable sales method and concluded that Maison Blanche was worth $10.3 million pre- and post-easement and that the easement had no value. The Tax Court in 2008 determined

that the easement had a value of $1.792 million and imposed a 40% payment for gross undervaluation.

Whitehouse appealed the 2008 Tax Court decision to the Fifth Circuit. The Fifth Circuit in 2010 remanded to the Tax Court and requested that the Tax Court reconsider all valuation methods, that it determine the parcel's highest and best use for purposes of the valuation, and that it consider the effect of the easement on the adjacent building, even if the easement itself did not specifically burden that building under Louisiana law. It also directed the Tax Court to determine whether the highest and best use would be as the luxury hotel actually being built or instead as a non-luxury hotel. The Tax Court in 2012 found that, on the date of the imposition of the easement, the proper valuation was not of the development of the luxury hotel but of a shell building suitable for conversion to a hotel. It determined that the value of the easement was $1.857 million. This resulted, once again, in the application of the gross undervaluation penalty.

The Court of Appeals affirmed the Tax Court's second decision. However, it vacated the enforcement of the gross undervaluation penalty. It found that obtaining a qualified appraisal, analyzing that appraisal, commissioning another appraisal, and submitting a professionally prepared tax return is sufficient to show a good faith investigation as required by law. It noted that it was skeptical of the Tax Court's conclusion that following the advice of accountants and tax professionals, as had been the situation here, was insufficient to meet the requirements of the good faith defense, especially in regard to a complex task that involved many uncertainties.

41. Letter Rulings 201421023 and 201421024 (Issued February 25, 2014; released May 23, 2014)

IRS concludes that annuity payments from charitable lead annuity trusts pursuant to the terms of previously executed charitable pledge agreements will not constitute self-dealing

Revocable living trusts created by each of Husband and Wife provided for testamentary Charitable Lead Annuity Trusts ("CLATS") to be created and funded at each settlor's death to satisfy the terms of previously executed, but still outstanding, charitable pledge agreements. The annuity payments from the CLATs were to be paid to a private foundation of which Husband and Wife were trustees. After the ruling request was submitted, Husband passed away.

One charitable pledge arose because various members of Husband and Wife's extended family agreed to donate money to support the creation of a new hospital foundation. Under the funding agreement for the hospital foundation, Husband and Wife's foundation was to donate a specific sum in ten equal installments. In addition, Husband agreed to contribute an additional amount under the agreement by funding the CLAT either during life or at death. For the second pledge, Husband and Wife caused the co-trustees of their private foundation to agree to donate certain sums to a museum. Wife, as trustee of her revocable trust, also agreed to donate certain funds to a museum. Part of this funding was to come through a testamentary CLAT to be created upon Wife's death.

The IRS first determined that Husband and Wife were disqualified persons with regard to both the foundation and the CLATs. In order to avoid any self-dealing, there would have to be a

determination that the specified payments by the foundation of the annuity payments from the CLATs were not direct or indirect uses of the foundation's assets for the benefit of disqualified persons since they were being used to satisfy the legal obligations of the Husband, Wife, or another disqualified person.

The IRS found that the agreement between the foundation and the hospital ran from the private foundation to the hospital foundation and did not personally obligate the Husband or Wife. Consequently, payment of this obligation did not constitute self-dealing. In addition, the obligation to fund specified payments to the hospital foundation for a term of years ran from the hospital to the trustees of the trust and did not personally obligate Husband or Wife. Consequently, this did not constitute self-dealing. A similar analysis was made with respect to the agreement with the museum. Since Husband and Wife were not personal obligors under the museum agreement, the payment by the foundation would not satisfy a legal obligation by the Husband or Wife. The same was true of any payment by the charitable lead annuity trust.

42. Schmidt v. Commissioner, T.C. Memo. 2014-159

Government loses on valuation of conservation easement

In 2000, Roy Schmidt purchased 40 acres of vacant land in Colorado for $525,000. He intended to subdivide and develop it. Subsequently, Schmidt agreed to develop his property with an adjacent property owned by another developer as a 108.8-acre subdivision. In 2003, Schmidt purchased the adjacent property which had yet to be developed.

At some point during the development process for the subdivision, Schmidt considered granting a conservation easement. An appraisal firm concluded that the value of the proposed conservation easement would be $1.6 million. Schmidt and his wife filed individual federal income tax returns for 2003, 2004, 2005, and 2006 for claiming a $1.6 million charitable deduction for the conservation easement. The deduction was too large to be taken in one tax year because of the percentage limitations applicable to charitable gifts.

The Service denied the income tax charitable deduction or alternatively determined that the value of the easement was $195,000 based on an appraisal it obtained.

Schmidt's appraiser had based his valuation on the value of the property as a subdivision. The Tax Court found that neither expert was convincing, and reduced the value of the easement to $1.15 million. However, the court did not impose the penalty for substantial understatement under Section 662 because it found that Schmidt had acted reasonably.

43. Letter Ruling 201321012 (Issued February 1, 2013; released May 24, 2013)

IRS rules favorably on tax consequences of gift of unitrust interest to charity

Husband and Wife, on different dates, created two charitable remainder unitrusts (CRUT) under which the unitrust amount would be paid to them until the death of the survivor. Upon the death of the survivor, the unitrust amount would pass to a designated charity. Subsequently, Husband

and Wife entered into an agreement with the designated charity under which they would relinquish any right to change the charitable beneficiaries of the two CRUTs, acknowledge that the charity was the sole remainder beneficiary of the two CRUTs, and convey to charity all of their respective rights to all remaining unitrust amounts.

Based on these facts, the IRS found that because Husband and Wife would irrevocably relinquish any right to change the charitable beneficiaries of the trust and because they would acknowledge that the charity was the sole remainder beneficiary of the trust, the gift of the remainder interest in the trust to charity would be complete. As a result, they would be entitled to a gift tax charitable deduction for the value of the remainder interests in the trust transferred to charity. They would also be entitled to both a gift tax deduction and an income tax deduction for the value of the unitrust interests in the two trusts transferred to the charity.

44. Letter Ruling 201426006 (Issued February 28, 2014; released June 27, 2014)

Judicial reformation of charitable remainder unitrust trust will not result in self-dealing

Husband and Wife created a charitable remainder unitrust trust which provided for distributions to Husband and Wife and their two children for each of their lifetimes with a designated charity as the remainder beneficiary. Husband and Wife passed away leaving the two children as trustees and sole remaining beneficiaries. Husband and Wife intended to create a standard charitable remaining unitrust. However, Husband and Wife's attorney used a form that created a net income charitable remaining unitrust which provided for an annual payout of the lesser of the net income of the trust or the fixed percentage of the fair market value of the assets.

The trustees asserted that it was not the intent of Husband and Wife to have an income limitation on the payouts. The trust had always been administered as a standard charitable remainder unitrust. The annual payout had at all times been the fixed percentage of the value of the assets despite trust income of less than that fixed percentage. The trust filed a state court petition seeking authority to reform the trust, and the court granted an order correcting and reforming the trust into a standard charitable remainder unitrust.

The Service found that the judicial reformation of the trust would not violate Section 664 and would not be an act of self-dealing. Because the reformation of the trust based on the scrivener's error would have the effect of increasing the annual amount payable to income beneficiaries, reformation might give rise to an act of self-dealing under Section 4941 as a transfer to or for the benefit of the disqualified person. However, the circumstances presented indicated that there was no self-dealing and the IRS was satisfied that the grantors never intended to create a net income charitable remainder unitrust. The evidence supporting this intention included the determination of the court that there was a scrivener's error; the administration of the trust as a standard charitable remainder unitrust; and the affidavit of one of the beneficiaries and the beneficiary's spouse indicating that the creators of the trust and the drafting attorney had several times stated that that there would be an annual payout of a fixed percentage. There was also no evidence that the income beneficiaries were reducing their own taxes or using the benefit of hindsight in making the change to the trust.

45. Letter Ruling 201450003 (Issued August 20, 2014; released December 12, 2014)

Reformed trust will qualify as a charitable remainder unitrust and be entitled to estate tax charitable deduction provided reformation is effective under local law and the reformed trust meets the requirements for a charitable remainder unitrust

Decedent, upon his death, created a trust to pay the income equally to decedent's mother and to beneficiary. Upon the death of decedent's mother or beneficiary, the trust assets were to be distributed to charity. The assets of the trust could also be used for the payment of taxes, debts, and legacies payable by the executor under the decedent's will. Decedent's mother predeceased decedent. The trust did not qualify for the estate tax charitable deduction because only the trust did not meet the requirements of a charitable remainder annuity trust or charitable remainder unitrust. The only split interest trusts that qualify for the estate tax charitable deduction are charitable remainder trusts and charitable lead trusts. As a result, decedent's estate filed a petition to reform the trust under Section 2055(e)(3) to qualify the trust as a charitable remainder unitrust.

As proposed, the current trust would be divided into a charitable remainder unitrust and an administrative trust. The charitable remainder unitrust would meet the requirements for a charitable remainder unitrust. Upon reformation, Y amount would be transferred to charitable remainder unitrust. The remaining trust property would be transferred to the administrative trust. Upon the completion of the administration of the estate and payment of all the estate expenses from the administrative trust, the trustees would transfer the remaining administrative trust assets to the charitable remainder unitrust.

The IRS determined that the proposed reformation met the requirements of Section 2055(e)(3) for a qualified reformation and therefore the new charitable remainder trust would qualify. It also noted that payment of estate taxes or administrative expenses from the administrative trust would not cause the charitable remainder unitrust to fail to qualify under Section 664.

46. Belk v. Commissioner, 774 F.3d 221 (4th Cir. 2014)

Husband and Wife are not entitled to an income tax charitable contribution deduction for a donation of a conservation easement on a golf course because the easement agreement allowed for substitutions of property

Mr. and Mrs. Belk formed a limited liability company, Olde Sycamore, LLC, to develop a golf course with surrounding residential lots which were later sold to builders. Olde Sycamore continued to own the golf course. Olde Sycamore was owned wholly by the Belks with 99% held by B. V. Belk and 1% by his wife Harriett.

In 2004, Olde Sycamore executed a conservation easement covering 184 acres of land on which the golf course now sits. The easement was transferred to the Smokey Mountain National Land Trust, Inc. The easement included a number of enforceable use restrictions, including a prohibition on the further development of the property and a requirement that the parcel be used for outdoor recreation. One right reserved by Olde Sycamore was the right to "substitute an area

of land owned by [it] which is contiguous to the conservation area for an equal or lesser area of land comprising a portion of the conservation area.

The easement also contained a savings clause stating that the trust could agree to amendments that might cause the easement to fail to qualify as a qualified conservation easement. On its 2004 income tax return, Olde Sycamore claimed a deduction of $10,524,000 for the donation of the easement to the trust which passed through to the Belks as the sole owners of Olde Sycamore, and which the Belks claimed as income tax charitable deductions on their 2004, 2005 and 2006 income tax returns. In 2009, IRS denied the income tax charitable deduction because of the substitution of property power granted to Olde Sycamore.

The Tax Court concluded the Belks were not entitled to claim an income tax charitable deduction because Olde Sycamore had not donated a qualified real property interest under Section 170(h)(1). This was because the conservation easement agreement permitted the Belks to change the property subject to the conservation easement. As a result, the restriction was not granted in perpetuity as required by Section 170(h)(2)(C).

The circuit court agreed that the easement failed to meet the requirement that a qualified real property interest means a restriction granted in perpetuity on the use of real property since the real property subject to the easement could be changed.

The circuit court noted that the language of the statute was clear. In addition, it also found that the savings provision in the conservation agreement was a condition subsequent which was invalid under Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944).

As a result, the circuit court affirmed the judgment of the Tax Court.

47. Mitchell v. Commissioner, ___ F.3d___ (10th Cir. 2015)

Charitable income tax deduction for conservation easement denied because mortgage on property was not subordinate to easement

In 1998, Charles and Ramona Mitchell purchased a 105 acre ranch in Colorado from Clyde Sheek. Charles Mitchell subsequently purchased a contiguous parcel with an additional 351 acres from Clyde Sheek in 2001. The parties agreed that after an initial down payment, Charles Mitchell would pay the balance for the second parcel in annual installments. In 2002, the Mitchells formed a family limited liability limited partnership called CL Mitchell Properties, LLLP and transferred the ranch land subject to Clyde Sheek's deed of trust to the partnership. In 2003, CL Mitchell Properties, LLLP placed a conservation easement over 180 acres of unimproved ranch land which the partnership owned. In 2004, Mr. and Mrs. Mitchell claimed an income tax charitable deduction of $504,000 for the conservation easement. In 2010, the IRS disallowed the income tax charitable deduction because the property was subject to Mr. Sheek's unsubordinated mortgage at the time of the donation. As a result, the conservation purpose was not protected in perpetuity as required by the Internal Revenue Code.

The Tax Court denied the Mitchell's claimed income tax charitable deduction concluding that the Internal Revenue Code and its implementation regulations strictly required that Sheek's mortgage be subordinated on the date of the donation in order to meet the requirement that an

easement be granted in perpetuity. Only in 2005, almost two years after the donation, did Sheek agreed to subordinate his interest in the ranch land to the easement. On appeal, the Tenth Circuit upheld the decision of the Tax Court.

Mr. Mitchell died in 2006 and Mrs. Mitchell, the surviving taxpayer, first argued that the mortgage provision and the regulations contained no explicit time frame for compliance. Mrs. Mitchell also claimed that the regulations entitled her to the deduction despite any failure to comply strictly with the mortgage subordination provision since the risk of forfeiture was low.

Mrs. Mitchell had also claimed that the mortgage subordination provision in the Treasury Regulations was arbitrary and capricious. The Tenth Circuit did not consider this argument because it was raised for the first time on appeal.

The IRS argued that the mortgage subordination provision was a bright line requirement which required any existing mortgage to be subordinated to the rights of the charitable organization as of the date of the donation irrespective of the risk of foreclosure or any alternate safeguards. Mrs. Mitchell claimed that she was entitled to the income tax charitable deduction despite the failure to subordinate at the time of the conveyance because the deed contained sufficient safeguards to protect the conservation purpose and perpetuity and that the remote future event provision acted as an exception to the mortgage subordination provision for giving "remote and harmless errors."

The Tenth Circuit, in interpreting Treas. Reg. § 1.170A-14(g), found that the mortgage subordination provision did not allow subordination at any time and that the IRS was entitled to demand strict compliance for the mortgage subordination provision irrespective of the likelihood of foreclosure. The court noted that the remote future event provision and the regulation provides that a deduction will not be disallowed "merely" because the interest that passes to donee organization may be defeated by the happening of some future event if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible. The court noted that this did not include the unexceptional risk of foreclosure. It noted that it was reasonable for the IRS to adopt an easily applied subordination requirement over a case by case fact specific inquiry into the financial strength or credit history of each taxpayer.

Consequently the denial of the income tax charitable deduction was upheld.

GENERATION-SKIPPING TRANSFER TAX

48. Letter Ruling 201406008 (Issued October 21, 2013; released February 7, 2014)

Estate granted extension to file certificate of mental incompetency

Decedent created a revocable trust and subsequently amended it, both on dates prior to October 22, 1986. Decedent subsequently died. Upon the death of decedent, the trust was split into two equal shares. The first share was for the benefit of decedent's niece and the second share was for the benefit of decedent's nephew. Upon the death of niece, the remainder of her share was to be paid to the grandchildren of decedent's cousin. Niece was still living at the time of the request for letter ruling.

Upon the death of nephew, the income of nephew's share was to be paid to nephew's wife for life, then to his daughter for life. Nephew died. Nephew's wife renounced her interest, and nephew's daughter then subsequently died. Upon the death of the last to die of nephew, nephew's wife and nephew's daughter, the remainder of the second share would be held in trust for the benefit of two charities. Apparently, no GST exemption was allocated to the trusts at decedent's death on the assumption that the trust was exempt because decedent was under mental disability to change the disposition of her property on October 22, 1986 and at all times thereafter up until the time of decedent's death.

The executor filed the form 706 for decedent, but failed to file a physician's certificate or other evidence of decedent's mental incompetency on October 22, 1986 and at all times thereafter until her death. Upon discovery of this, a request for letter ruling was filed requesting an extension of time to file the certificate of mental incompetency. The IRS found that the requirements of Treas. Reg. § 301.9100-3 had been met. Under Treas. Reg. § 301.9100-3, a request for an extension of time will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interest of the government.

The IRS specifically noted that it expressed no opinion as to whether the decedent was under a mental disability on and after October 22, 1986 that would allow the trust to be grandfathered from the generation-skipping tax. This would have to be resolved during audit.

49. Letter Ruling 201418001 (Issued January 9, 2014; released May 2, 2014)

IRS concludes that no GST tax was or is due upon any distributions from a trust since the trust had an inclusion ratio of zero

Decedent died and was survived by spouse, six children and two grandchildren. One child predeceased spouse and was survived by her children. The spouse subsequently died. Two of decedent's children were children from a prior marriage. Decedent's will appeared to provide for the creation of a marital trust and a credit shelter trust. The spouse was trustee of the credit shelter trust. Under the credit shelter trust, the trustee could distribute net income and principal to the spouse and to spouse's descendants. Upon spouse's death, the trust was to terminate and all the assets would be distributed to decedent's descendants, per stirpes. It was represented that the credit shelter trust had an inclusion ratio of zero for GST tax purposes since sufficient GST exemption was allocated to the trust.

One of the children from decedent's first marriage petitioned to have the spouse removed as trustee of the trust and for damages for breach of fiduciary duties by the spouse as trustee. Eventually, the spouse and the decedent's children and grandchildren entered into a settlement agreement under which they agreed to a reformation of the trust to include having a corporate trustee as a successor trustee and for mandatory distributions of net income in certain situations. Two years after the family entered into the settlement agreement, the court entered an order accepting the settlement agreement. The modifications of the trust were not to be effective until the issuance of a favorable private letter ruling on the tax consequences.

The IRS noted that decedent's estate allocated sufficient GST exemption to the trust so that the trust had an inclusion ratio of zero. It noted that no guidance has been issued concerning a

modification that may affect the status of the trust that is exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. However, it further noted that, at a minimum, a modification that would not affect the GST status of a "grandfathered trust" should similarly not affect the exempt status of a trust such as the credit shelter trust. After spouse's death, the family entered into a second settlement agreement that provided for an outright distribution of the remaining property of the trust to the surviving children and to the children of the one pre-decreased child.

The IRS found that the trust had an inclusion ratio of zero and that none of the terms of the judgment entered by the court or the second family agreement would cause the trust to have inclusion ratio greater than zero and that no GST tax was owed.

50. Letter Ruling 201422005 (Issued January 23, 2014; released May 30, 2014)

Settlement of litigation with respect to a grandfathered GST trust will not have adverse tax consequences

This letter ruling involved a testamentary trust that was grandfathered for GST tax purposes because it was created prior to September 26, 1985. The trust was primarily for the benefit of the decedent's relatives, spouse, and issue. Upon the death of the last survivor of decedent's children and spouse, the trust was to terminate and the principal was to be distributed on a per capita basis to decedent's then living grandchildren. When this letter ruling was requested, one child, eleven grandchildren, and thirteen great-grandchildren were the beneficiaries of the trust. The trust had been the subject of litigation for many years. The child requested that the trust be terminated and the court, after litigation, found that the purpose of the trust had been filled and that the trust could terminate. Under the settlement agreement, each income beneficiary who was not a remainder beneficiary was to receive a distribution representing the actuarial value of the income beneficiary's interests in the trust.

The IRS declined to rule on the issue of whether the contemplated termination distributions would not cause the grandchildren to recognize income upon termination of the trust except to the extent that the distributions carried out distributable net income. It also declined to rule on whether, upon termination of the trust, each recipient of the termination distribution would recognize capital gain in the amount of his or her distribution. It did rule that the terminating distributions pursuant to court order would not cause the trust to become subject to GST tax and that the termination distributions would not result in any taxable gift.

The Service noted that Treas. Reg. § 26.2601-1(b)(4)(i) provides that a court-approved settlement of a bona fide issue regarding the administration of a trust will not cause an exempt trust to be subject to GST tax if the settlement is the result of arms-length negotiations and is within the range of reasonable outcomes. It found that the test had been met here.

The Service also found that no gift tax arose because the agreement was based on a valid enforceable claim and produced an economically fair result. It noted that the terms of the agreement were the product of arm's-length negotiations and determined that the settlement

agreement reflected the rights of the parties under applicable state law. As a result, there were no gift tax consequences from this transaction.

51. Letter Ruling 201418005 (Issued December 12, 2013; released May 2, 2014)

Exercise of a power of appointment by beneficiary of grandfathered GST trust to appoint assets from one trust to a second trust will not be a constructive addition to either trust and will not cause distributions from second trust to be subject to generation-skipping tax

Grantors created an irrevocable trust (Trust A) for the primary benefit of granddaughter prior to September 25, 1985. Consequently, the trust was grandfathered from the GST tax. Granddaughter was the sole beneficiary of the trust during her life. Granddaughter had limited inter vivos and testamentary powers of appointment to appoint the assets to Grantors' then-living issue, either outright or to other trusts for their benefit. Granddaughter proposed to appoint the assets of Trust A to Trust B, an existing irrevocable trust for the benefit of her son, which had terms for distributions to granddaughter during her life that were the same as the terms in Trust A, the original trust.

The IRS first noted that since granddaughter's powers of appointment were not exercisable in favor of herself, her estate, or the creditors of either, they were not general powers of appointment and would not be subject to estate tax.

The Service then looked at the generation-skipping tax consequences of the exercise of the power. It specifically looked at Treas. Reg. § 26.2601-1(b)(1)(v)(B). An exercise of a power of appointment will not be treated as an addition to a trust that will cause adverse generation-skipping tax consequences if (1) such power of appointment creates an irrevocable trust that is not subject to GST tax and (2) if exercised, the power of appointment is not exercised in a manner that would postpone or suspend the vesting of the trust beyond the governing perpetuities period. The perpetuities period is determined taking into account the extent that any new power created by the exercise of the current power could postpone or suspend vesting. The ruling found that both these requirements were met and that the appointment of the Trust A assets to Trust B would not be a constructive addition to either trust and would not cause distributions from Trust B to be subject to generation-skipping tax.

52. Letter Ruling 201425007 (Issued February 25, 2014; released June 20, 2014)

Exercise of special power of appointment will not be considered a constructive addition to a grandfathered GST Trust and will not cause distributions to be subject to GST tax

This letter ruling involved a pre-September 25, 1985 irrevocable trust that was grandfathered from the generation-skipping tax. The primary life beneficiary of the trust was given a testamentary power of appointment to various family members. The primary life beneficiary's estate, creditors, and the creditors of his estate were specifically excluded as permissible appointees.

The primary beneficiary proposed to execute a codicil to his will under which the share the trust created for each beneficiary would be held in a successor trust for the benefit of such remainder beneficiary. Each successor beneficiary would have a testamentary limited power of appointment to descendants of the primary beneficiary. The original trust provided that the trust would terminate at the end of the common law perpetuities period. The IRS ruled that the exercise of the limited power of appointment by the primary beneficiary would not subject the grandfathered trust to GST tax. It analyzed the provisions of Treas. Reg. § 26.2601-1(b)(1)(v)(B). Under this section, the release, exercise, or lapse of a special power of appointment will not cause adverse generation-skipping tax consequences if the power is created in a grandfathered GST trust and, in the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting of the property beyond the common law rule against perpetuities period as determined from the initial creation of the trust. In addition, the exercise of the power of appointment could not postpone the termination of the trust for a term of years that will exceed 90 years from the day of the creation of the trust. The regulation also provides that if a power is exercised creating another power, it is deemed to be exercised to whatever extent the second power may be exercised. The IRS found that the two requirements of the Treasury Regulation were met. The trust was a grandfathered trust. In addition, the primary beneficiary's power of appointment and the limited powers of appointment given to the remainder beneficiaries could not be exercised to extend the term of the trust beyond the original perpetuities period.

53. Letter Ruling 201438016 (Issued May 28, 2014; released September 19, 2014)

Modification of a grandfathered GST Trust will not ungrandfather the GST Trust

In this letter ruling, the trustee sought to modify a pre-September 25, 1985 trust that was grandfathered from the imposition of the GST tax. The independent corporate trustee proposed to file a petition with the probate court to resolve an ambiguity in the governing instrument regarding the distribution of the proceeds from a partial sale of real property. The governing will provided for the distribution of the real property but not the proceeds of the sale of the real property. The proceeds from the sale of the real property had been and would remain segregated. Judicial action would also resolve an ambiguity as to the distribution of the real property to the blood issue of a grandson "by right of representation." Neither the will nor any state statute defined "by right of representation" for purposes of distributing the assets. As a result, the probate court's construction would resolve a bona fide issue regarding the proper management and distribution of the assets in the trust. One-third of the remaining estate was to be held in trust for the benefit of a charity, and two-thirds of the remaining trust was to be distributed outright to the "blood issue" of the grandson.

The IRS found that the proposed modification of the trust would not cause the trust to lose its exempt status since the modification would resolve an ambiguity. Treas. Reg. § 26.2601-1(b)(4)(i)(C) provides that a judicial construction of the governing instrument to resolve an ambiguity in the terms of an instrument will not ungrandfather a trust if a bona fide issue is involved and the construction is consistent with applicable state law as applied by the highest court of the state.

The judicial construction was necessary to resolve the ambiguity in the testator's will regarding the distribution of the proceeds of real estate which had been sold. The IRS noted because the beneficial interests, rights and expectancies of the beneficiaries were the same both before and after the proposed judicial construction, no gifts will be deemed to have been made by any beneficiary to any other beneficiary.

54. Letter Ruling 201432004 (Issued March 19, 2014; released August 8, 2014)

Taxpayer entitled to extension of time to allocate GST exemption

Grantor established an irrevocable trust for the benefit of his three children and their descendants. The trust was funded with stock. The trust was intended to last for the common law rule against perpetuities for the benefit of grantor's descendants.

An accounting firm prepared the gift tax return. It reported the gift as being made to the wrong trust and none of grantor's GST allocations was allocated to the trust. Grantor requested an extension of time to make a late allocation of GST exemption.

Under Treas. Reg. § 301.9100-3, the IRS may grant a reasonable extension of time for making an election when the taxpayer can show that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

The IRS held that the requirements of the Treas. Reg. § 301.9100-3 had been satisfied and an extension of time to allocate GST election was permitted.

55. Letter Ruling 201432005 (Issued March 5, 2014; released August 8, 2014)

Modification of four grandfathered irrevocable trusts will not cause the trusts to lose their exempt status for GST tax purposes

Prior to September 25, 1985, settlor created four irrevocable trusts for the benefit of each of her four children. Each trust was grandfathered from the GST tax.

Each trust had previously been modified to provide for successor individual trustees, to give the individual trustee the sole power to make investment decisions, to give the primary beneficiary the power to replace the independent trustee, to provide that the successor independent trustee could not be a related or subordinate party, and to provide that none of a child or a child's issue or a child's spouse could act as trustee of a trust for their benefit.

The settlor and the current trustees proposed to add an individual trustee for the purpose of making distribution decisions. This would allow either the distribution trustee or the independent trustee to make the distribution decisions. The distribution trustee could not be a related or subordinate party.

The IRS first held that the proposed modifications to the four trusts were administrative in nature and therefore did not cause the beneficiary's interest in his or her trust to be includable and the beneficiary's gross estate for purposes of Section 2033 nor did they constitute a transfer within the meanings of Sections 2036 and Sections 2038.

The IRS next concluded that the proposed modifications would not cause the settlor to be treated as having exercised or released a general power of appointment nor would it cause any beneficiary of the trust to be treated as having exercised or released a general power of appointment.

Finally, the IRS held that the proposed modifications of the four trusts since they were administrative in nature would not cause any shifting in beneficial interests to the lower generations or extend the time for vesting of any beneficial interest. Therefore, the four trusts would not lose their exempt status from GST tax.

56. Letter Ruling 201450002 (Issued August 12, 2014; released December 12, 2014)

Executor granted extension of time to make QTIP election for a martial trust and then sever a marital trust into separate trusts

Under decedent's estate plan, a marital trust was created which could be divided to reflect a partial QTIP election. On Schedule M of the federal estate tax return, one asset, described as "Account", was listed as passing to the spouse because the spouse was listed as the sole beneficiary of the Account. In fact the marital trust was the beneficiary of the Account. It was represented that the marital trust should have been divided into two separate trusts, a QTIP marital trust and a non-QTIP marital trust and Account should have been allocated to the QTIP trust and a QTIP election should have been made for the Account and the QTIP trust. The other assets listed on Schedule M were in a non-QTIP marital trust for which no marital deduction should have been taken since those assets appear to have been sheltered by decedent's applicable exclusion amount. The error was discovered when the executor called Company to have the Account transferred to the spouse. Company did exhaustive research to determine that the marital trust was the beneficiary of the Account.

Under Treas. Reg. § 301.9100-3, requests for relief will be granted when a taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer failed to make the election because, after exercising reasonable diligence, the taxpayer was unaware of the necessity for an election. In addition, a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

The IRS determined that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and the executor was granted an extension of time to divide the martial trust into a QTIP trust and a non-QTIP trust and to make a QTIP election with respect to the QTIP marital trust and the Account.

57. Letter Ruling 201447014 (Issued August 7, 2014; released November 21, 2014)

Extension of time granted to treat a marital trust as two separate trusts, one of which has a zero inclusion ratio by reason of the automatic allocation of decedent's GST exemption

Upon decedent's death, Family Trust was divided into a survivor's trust, a marital trust, and a bypass trust. The survivor's trust contained Spouse's separate property and Spouse's share of the community property. Decedent's unused applicable exclusion amount sheltered the property placed in the bypass trust. The balance was placed in the marital trust. Spouse subsequently disclaimed her interest in the bypass trust.

Spouse hired Attorney to prepare the federal estate tax return. Attorney treated the marital trust as QTIP property. Attorney also elected not to have a reverse QTIP election made for the marital trust. Attorney allocated part of decedent's GST exemption to the bypass trust, but did not allocate decedent's remaining GST exemption. Subsequent to the filing of the Form 706, Treas. Reg. § 26.2652-2(c) was issued. This regulation provided a transitional rule that allowed certain trusts subject to a "reverse" QTIP election, to which GST exemption had been allocated, to be treated as two separate trusts so that only a portion of the trust would be treated as subject to the reverse QTIP election and that portion be treated as having a zero inclusion ratio. The deadline for making the election set forth in the transitional rule was June 24, 1996. During spouse's term as trustee, Attorney never advised spouse of the ability to make the election under the transitional rule. Only when a new trustee was appointed, did trustee obtain advice from a law firm regarding the availability of the transitional rule.

The trustee requested that the automatic allocation rules of Section 2632(e) would apply to automatically allocate decedent's unused GST exemption to the marital trust. The trustee also requested an extension of time under Treas. Reg. § 301.9100-3 to elect to treat the marital trust as two separate trusts pursuant to the transitional rule in Section 26.2652-2(c) so that one trust had an inclusion ratio of zero due to the previous automatic allocation of decedent's unused GST exemption to the marital trust and the other had inclusion ratio of one for GST purposes. Treas. Reg. § 301.9100-3 permits an extension of time to be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that the granting of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the election.

In this letter ruling, the Service found that the balance of decedent's GST exemption after the allocation to the bypass trust was automatically allocated to the marital trust under Section 2632(e). In addition, the requirements of Treas. Reg. § 301.9100-3 were satisfied so that the marital trust could be divided into an exempt and non-exempt trust and all of decedent's GST exemption automatically allocated to the marital trust would be allocated to the exempt trust.

58. Letter Ruling 201451005 (Issued September 4, 2014; released December 19, 2014)

Proposed modifications and division of four grandfathered irrevocable grantor trusts will not have adverse GST tax consequences

Grantor created four irrevocable trusts and funded them prior to September 25, 1985. Consequently, the trusts were grandfathered from the GST tax. Each of the trusts benefitted a specific grandchild and his or her descendants. The trusts were to last for the common law perpetuities period.

The trustees proposed to divide the four trusts into nine trusts so that each great-grandchild would have a separate trust. Each divided trust would receive a pro rata portion from the respective existing trust based on the number of the children of the grandchild for whose benefit the trust was held. After the division, the divided trusts would continue under the same terms and for the same duration as originally provided in the trust agreement.

The distribution provisions would provide that the distributions for the benefit of each of the grandchildren would be made equally from the divided trust of which each was a separate beneficiary.

The Service first ruled that since the proposed modifications and the division of each trust would not shift a beneficial interest to any beneficiary who occupied a lower generation than the person or persons who held the beneficial interests prior to the modifications and the division and would not extend the time for vesting of any beneficial interest beyond the period provided in the trust agreement, the division would not cause the trusts to become subject to GST tax purposes since this met the requirements of Treas. Reg. § 26.2601-1(b)(4)(i)(D).

In addition, the IRS ruled that the proposed modifications and the division of the trusts would not have any adverse estate tax consequences to the beneficiaries and would not cause any portion of the assets of the trusts to be subject to estate tax.

Finally the IRS ruled that proposed modifications of the trusts would not constitute a transfer of property of any beneficiary of the trusts since after the transfer, the beneficiary's rights would remain the same.

59. Letter Ruling 201451025 (Issued September 5, 2014; released December 19, 2014)

Extension of time granted to estate to allocate GST exemption to four trusts incorrectly treated as non-taxable for GST tax purposes

Decedent made cash gifts to four trusts with GST tax potential. In preparing the gift tax return, the tax professional incorrectly reduced the amount of GST exemption allocated to each trust by the annual exclusion amount. The donor died one year after making the gifts. The now deceased donor had sufficient GST exemption to allocate to the four transfers that were incorrectly treated as non-taxable for GST purposes. In this situation, the automatic allocation rules for GST exemption to an indirect skip did not apply since the transferor may prevent the automatic

allocation of GST exemption by making an affirmative election of GST exemption on a gift tax return under Treas. Reg. § 26.2632-1(b)(2)(ii).

The Service determined that the requirements of Treas. Reg. § 301.9100-3 for granting an extension of time had been met since the taxpayer had provided evidence to show that the taxpayer acted reasonably and in good faith and that granting relief would not prejudice the interests of the government. This was because a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make, or advised the taxpayer to make, the election.

60. Letter Ruling 201448018 (Issued September 2, 2014; released November 28, 2014)

Merger of two trusts will not have adverse GST tax consequences

Trust One was created under the provisions of Wife's will. Wife died prior to September 25, 1985 and, consequently, Trust One was grandfathered for GST Tax purposes. Trust One permitted discretionary payments of net income to Wife's grandchildren. Each grandchild was given a broad testamentary limited power of appointment. Trust One was to terminate upon the death of the last to die of the grandchildren of Wife living at the time of Wife's death.

Husband created Trust Two upon his death which was also prior to September 26, 1985. Trust Two's provisions were substantially identical to the provisions of Trust One. Each of Trust One and Trust Two were previously modified to change the provisions for the trustee without any effect on the dispositive provisions.

State law permitted two trusts to be combined into a single trust if the result did not materially impair the rights of any beneficiary or adversely affected the purposes of the trust. The trustees of Trust One and Trust Two proposed to merge the two trusts with Trust Two being the surviving trust. The beneficiaries of Trust One and Trust Two before the merger would be the beneficiaries of Trust Two after the merger.

The Service noted that the proposed merger was similar to Example 6 in Treas. Reg. § 26.2601-1(b)(4)(i)(E) in which, in 1980, Grantor established an irrevocable trust for the benefit of Grantor's child A, and A's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the two trusts were identical. In 2002, the appropriate local court approved the merger of the two trusts into one trust to save administrative costs and enhance the management of the investments. The merger of the two trusts under the example did not shift any beneficial interest in the trust to a beneficiary in a lower generation. In addition, the merger did not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. As a result, the trust that resulted from the merger would still be exempt from the generation-skipping tax.

Based on the similarity of the facts in Example 6 and in the Ruling Request, the Service determined that the proposed merger of Trust One into Trust Two would not affect the grandfathered status of either trust and would have no adverse GST tax consequences.

61. Letter Ruling 201450018 (Issued June 3, 2014; released December 12, 2014)

Spouse granted extension of time to allocate GST exemption

Grantor established an irrevocable trust for the benefit of three children and their descendants. Upon grantor's death, the trustees are to divide the trust into three equal shares, with one share for each of the three children. After a child's death, the property was to be divided and held in separate trusts for the benefit of each grandchild with distributions to the beneficiary of his or her share of 1/3 at age 25, 1/3 at age 30, balance at age 35.

An attorney prepared the gift tax returns for grantor and grantor's spouse. Grantor and spouse elected to split the gifts under Form 709. Grantor and spouse each reported half of the gifts made to the trust on their respective returns. Grantor and spouse had intended for trust to have a zero inclusion ratio. However, attorney allocated the exemption amount for the entire value of the combined gifts on grantor's return and no exemption was allocated on spouse's return. Attorney then died and the error was discovered when attorney's files were transferred to another attorney.

The trustees requested an extension of time to allow spouse to allocate GST exemption to the transfers of the trust in year one. The IRS granted the request because it found that the requirements of Treas. Reg. § 301.9100-3 had been met because a taxpayer will be granted an extension of time if it can show that a taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith and the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

In Giustina v. Commissioner, Unpublished Opinion (9th Cir. 2014), the Ninth Circuit reversed the decision of the Tax Court in a valuation case in which the issue was the amount of the discount for a minority interest in a limited partnership.

62. Letter Ruling 20150029 (Issued November 24, 2014; released March 6, 2015)

Trustees granted extension of time to allocate GST Exemption

Two decedents executed an irrevocable trust under the terms of which one trust was created for the benefit of the son and his descendants and one trust was created for the benefit of daughter and her descendants. These two trusts had GST tax potential. The decedents also established trusts for their grandchildren which qualified for the Gallo exemption.

The decedents retained an accounting firm to prepare the gift tax returns. On the returns, the GST exemption was incorrectly added to the gifts to the grandchildren's trusts but not allocated to the son's trust and the daughter's trust. Upon each decedent's death, the available GST exemption was automatically allocated under Section 2632(c) which was renumbered as Section 2632(e) on January 1, 2001. The decedent's estates were requesting an extension of time under Treas. Reg. § 301.9100-3 so that the GST exemption automatically allocated to the son's trust

and the daughter's trust as a result of the death of each of the decedents be effective as of the date of the original transfers to son's trust and daughter's trust.

Under Treas. Reg. § 301.9100-3, relief will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interest of the government. The taxpayer is to have deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional. The IRS concluded the requirements of Treas. Reg. § 301.9100-3 had been satisfied.

63. Letter Rulings 201509002 – 201509018 (Issued October 16, 2014; released February 27, 2015) and 201510009 – 201510023 (Issued October 16, 2014; released March 6, 2015)

Plan for two similar GST trusts to make a coordinated sale of farm properties to a beneficiary will not cause either trust to lose GST exempt status.

Each of these letter rulings involves the plan for two similar GST exempt trusts to make a coordinated sale of farm properties to a beneficiary. Each trust was created and became irrevocable before September 25, 1985 and therefore was grandfathered from GST Tax Each of the two trusts together owned a farm. The trustees of both trusts decided that it was in the best interest of each trust to sell the property in a coordinated sale. The property was currently zoned for agriculture and residential use and for public land use. The farm had been on the market for several years. The proposed purchaser was a limited partnership owned by a lineal descendant of the grantors who was also a beneficiary of one of the two trusts and a contingent beneficiary of the other trust. The sale would be approved by a court.

Generally, under Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1), a modification of a trust will not cause a grandfathered trust to lose its GST exemption if the modification does not shift a beneficial interest to a beneficiary in a lower generation and does not extend the period for the vesting of the interests in the trust beyond the period provided for in the original trust.

The following rulings were requested:

1. The execution and carrying out of the terms of the agreement of sale would not cause either trust to lose its GST exempt status.

2. Entering into the agreement of sale and carrying out the terms would not cause any beneficiary of either trust to make or be deemed to have made a taxable gift to any other beneficiary.

3. The sales transaction would not cause any beneficiary to be required to have adverse estate tax consequences with respect to assets owned by Trust 1 or Trust 3 as long as the assets remained in the trust.

The IRS found that the execution and carrying out the terms of the sales agreement and the sale of the farm were administrative in nature and would not shift a beneficial interest in either trust to any beneficiary in a lower generation. In addition, the execution of the sales agreement and

the sale of the farm would not extend the time for the vesting of any beneficial interest in either trust beyond the period originally provided in the trust documents.

The IRS also found that as long as a court approved the sale as one that was fair, and reasonable with arm's length terms, there would be no taxable gifts to any beneficiary or to the purchaser. In addition, because the trustees of the two trusts proposed to sell the farm, there would be no transfers by the beneficiaries of assets to either the trusts or any other trust and therefore none of Sections 2036, 2037 or 2038 would apply. Therefore there would be no adverse estate tax consequences with respect to the property in the trust, unless property in the trust was distributed to the beneficiaries at some point.

ASSET PROTECTION

64. Mississippi Qualified Disposition in Trust Act (April 23, 2014)

Mississippi enacts self-settled asset protection trust legislation

On April 23, 2014, the Governor of Mississippi signed House Bill 846 which was titled the "Mississippi Qualified Disposition in Trust Act." The new act is codified in Mississippi Code Sections 91-9-701 et seq. and is effective July 1, 2014. With the enactment of this act, Mississippi joins Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming as the states with similar laws that permit settlors to create irrevocable trusts, be a discretionary beneficiary of the trust, and receive spendthrift protection from creditors. In addition, Oklahoma has a more restrictive form of self-settled or domestic asset protection trust legislation and some commentators believe that Colorado also offers some protection to settlors (who are also beneficiaries) of certain types of irrevocable trusts.

The Mississippi Act appears to follow the Tennessee Investment Services Trust Act which was enacted in 2007. Under the Mississippi Act, a settlor who desires spendthrift protection against creditors can transfer assets to an irrevocable trust which incorporates Mississippi law with respect to the validity, construction, and administration of the trust and which has an independent Mississippi trustee and be a discretionary beneficiary of the income and principal of the trust. The Mississippi Act specifically provides for the appointment of advisers to make investment decisions. The Mississippi trustee must materially participate in the administration of the trust through such activities as (i) the custody of some of the property in Mississippi, (ii) maintaining records of the trust on an exclusive or non-exclusive basis, and (iii) preparing or arranging for the preparation of income tax returns.

The settlor of a Mississippi Qualified Trust can retain the following powers or rights (among others) without losing spendthrift protection:

1. The power to veto a distribution from the trust.
2. A limited testamentary power of appointment.
3. The right to receive a payment from a charitable remainder annuity trust or charitable remainder unitrust.

4. The right to receive an annual unitrust payment from a private unitrust that is not in excess of five percent.

For a transfer to a Mississippi Qualified Trust to be effective, the settlor, before making the transfer to the trust, must sign a "Qualified Affidavit" which states:

1. The transferor has full right, title, and authority to transfer the assets.
2. The transfer will not render the transferor insolvent.
3. The transferor does not intend to defraud a creditor by transferring assets to the trust.
4. There are no unidentified pending or threatened court actions against the transferor.
5. There are no unidentified pending or threatened administrative proceedings against the transferor.
6. The transferor does not intend to file for bankruptcy.
7. The assets being transferred were not derived from unlawful activities.

One unique feature of the Mississippi Act is that the settlor must secure and have in place before the transfer a general liability insurance policy and, if applicable, a professional liability policy with policy limits of at least $1 million for each such policy.

The Mississippi Act provides a two-year statute of limitations period during which a creditor can bring an action against the trust. In addition, the Mississippi Act permits the following types of claims against a Mississippi Qualified Trust at any time:

1. Claims for spousal support and alimony and for child support.

2. Tort claims for death, personal injury, or property damage that occur at any time and are caused by the settlor or for which the settlor is vicariously liable. This provision makes the spendthrift protection offered by the Mississippi Trust to settlors less effective than the protection provided by the domestic asset protection trust laws of other states. This provision may owe its inclusion in part to the aftermath of the decision of the Mississippi Supreme Court in <u>Sligh v. First National Bank of Holmes County</u>, 704 So.2d 1020 (Miss. 1997), in which it undermined the protection conferred by a spendthrift trust by ruling that the assets of a spendthrift trust for a third party beneficiary may be reached by a beneficiary's tort creditors. This decision was overturned by the Mississippi legislature in 1998. The inclusion of this provision may also reflect the strength of the plaintiffs' bar in Mississippi.

3. Claims of the State of Mississippi or any political subdivision including court restitution in a criminal matter.

4. Claims of a creditor up to $1.5 million if the transferor fails to maintain the required $1 million general liability or professional liability policies.

The Mississippi Act specifically provides liability protection to the trustee, advisers to the trust, and any person involved in the counseling, drafting, preparation, execution, or funding of a Mississippi Trust. This protection extends to the creation and funding of limited partnerships

and limited liability companies, the units in which are subsequently transferred to the Mississippi Trust.

Several provisions of the Mississippi Act or other Mississippi laws make the Mississippi Qualified Trust less attractive than the domestic asset protection trusts in other jurisdictions. For one, Mississippi has the common law Rule Against Perpetuities while other domestic asset protection states have either extended or eliminated the Rule Against Perpetuities. Mississippi has a state income tax unlike many of the other domestic asset protection states. Finally, some commentators have noted that the possible loss of protection against creditors if the settlor fails to maintain the required liability insurance may prevent a transfer to the Mississippi Qualified Trust from being a completed gift.

65. Clark v. Rameker, ___ U.S. ___, 134 S. Ct. 2242 (June 12, 2014)

Supreme Court holds that inherited IRAs are not exempt under the Bankruptcy Code

Before the U.S. Supreme Court rendered its decision in the case, previous court decisions were split on the issue of whether inherited Individual Retirement Accounts, or IRAs, were exempt from the claims of a bankruptcy trustee. An inherited IRA is an IRA that is received by the nonspousal beneficiary of a deceased IRA owner.

In Rameker, when the petitioners filed for Chapter 7 Bankruptcy (the liquidation of a debtor's nonexempt property and the distribution of the sale proceeds to the creditors), they sought to exclude roughly $300,000 in inherited individual retirement account from the bankruptcy estate. The petitioners invoked the "retirement funds" exemption under Section 522(b)(3)(C) of the Bankruptcy Code. The Bankruptcy Court concluded that an inherited IRA does not share the same characteristics as a traditional IRA and disallowed the exemption. The District Court reversed, explaining that the exemption covers any account in which the funds were originally accumulated for retirement purposes. The Seventh Circuit disagreed and reversed the District Court.

The Supreme Court, in a unanimous decision, held that the ordinary meaning of "retirement funds" within the meaning of the Bankruptcy Code should be properly understood as the sums of money set aside for the day on which an individual stops working. Three legal characteristics of inherited IRAs provide objective evidence that they do not contain such funds:

- First, a holder of an inherited IRA may never invest additional money in the account.
- Second, holders of an inherited IRA are required to withdraw money from the accounts, no matter how far they are from retirement.
- Third, the holder of an inherited IRA may withdraw the entire balance of the account at any time and use it for any purpose without penalty.

The Court noted that allowing debtors to protect funds in traditional and Roth IRAs ensures that the debtors will be able to meet their basic needs during their retirement years. In contrast, the legal characteristics of an inherited IRA do not prevent or discourage an individual from using the entire balance immediately after bankruptcy for purposes of current consumption. The court

also noted that the retirement funds exemption should not be read in a manner that would convert the bankruptcy objective protecting a debtor's basic needs into "a free pass." The Supreme Court rejected the various arguments made by the petitioners to show that the funds in an inherited IRA are truly retirement funds.

FIDUCIARY INCOME TAX

66. Treasury Regulation § 1.67-4 (May 8, 2014)

IRS publishes Final Regulations under Section 67 on deductibility of fiduciary expenses; postpones effective date

On May 8, 2014, the IRS issued final regulations regarding which costs or expenses incurred by estates and non-grantor trusts are subject to the 2-percent floor for miscellaneous itemized deductions under Section 67. These regulations can be found at Treas. Reg. § 1.67-4.

Generally, the final regulations are substantively similar to the 2011 proposed regulations and provide that an expense is subject to the 2-percent floor if "it is included in the definition of miscellaneous itemized deductions under Section 67(b), is incurred by an estate or non-grantor trust, and commonly or customarily would be incurred by a hypothetical individual holding the same property." The regulations provide guiding principles and examples, but they leave a number of questions unanswered regarding the applicability of these principles. In particular, the regulations leave fiduciaries with further questions about the deductibility of what the regulations call "investment advisory fees," whether or not those fees are bundled with other fiduciary expenses.

On July 17, 2014, the IRS postponed the effective date of these regulations and provided that the regulations will apply to all estates and non-grantor trusts with tax years beginning on or after January 1, 2015. This postponement gives fiduciaries and their advisors more time to develop procedures to properly implement the requirements of these regulations.

Postponement and Uniformity of Effective Date

By an amendment dated July 17, the effective date of these regulations is now January 1, 2015; this means that the regulations will apply only to a taxable year of any trust or estate that begins on or after January 1, 2015.

Initially, the regulations would have applied to taxable years beginning on or after May 9, 2014. That is, the regulations would have immediately applied to an irrevocable non-grantor trust created on or after May 9, 2014, and to the estate of an individual who died on or after May 9, 2014. In addition, the regulations would have applied prior to January 1, 2015, to an existing fiscal-year estate with a taxable year beginning between May 9, 2014, and January 1, 2015. But as for existing trusts with calendar years, the typical case the writers of the regulations may have had in mind, the regulations would have taken effect exactly on January 1, 2015.

Upon publication of the final regulations, the American Bankers Association and fourteen state bankers associations requested a delay in the enforcement of the regulations so their members

could properly develop procedures to comply with the regulations, particularly procedures to unbundle their fiduciary fees in compliance with the regulations in a fair, consistent and accurate manner.

The regulations now will not apply to any trust or estate prior to January 1, 2015, giving all fiduciaries and their advisors more time to digest and respond to these regulations.

Applicability of the 2-Percent Floor

According to Section 67(a), individual miscellaneous itemized deductions are allowed "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." Under Section 67(e), in the case of a trust or estate these deductions are treated in the same manner as in the case of an individual, except that "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate … shall be treated as allowable in arriving at adjusted gross income" and thus are not subject to the 2-percent floor.

The final regulations under Section 67(e) provide generally that a cost incurred by a trust or estate is subject to the 2-percent floor if the cost "commonly or customarily would be incurred by a hypothetical individual holding the same property."

This test of "commonly or customarily" incurred costs was endorsed by the U.S. Supreme Court in Knight v. Commissioner, 552 U.S. 181 (2008). In that case, the Supreme Court, in interpreting Section 67, adopted the test of the Federal and Fourth Circuit Courts of Appeals that an expense "would not have been incurred" by the estate or trust if it was a cost "commonly or customarily" incurred by an individual holding the same property. The Supreme Court rejected the test used by the Second Circuit that would have allowed a cost to be exempt from the 2-percent floor only if the cost "could not have been incurred" by an individual.

Building on this general test of costs that are "commonly or customarily" incurred by individuals, the regulations provide a number of examples of such costs.

Ownership Costs. In Treas. Reg. § 1.67-4(b)(2), the regulations provide that costs that are incurred "simply by reason of being the owner of the property" are subject to the 2-percent floor. These costs "include, but are not limited to," certain fees that would be incurred by any owner, including condominium fees, insurance premiums, and maintenance and lawn service costs.

One might first note that these categories do not distinguish between subcategories of expenses that might be more typical of ownership by a fiduciary. For example, a fiduciary might feel a greater incentive to secure ample insurance for a given property, and a fiduciary also typically would need to pay for maintenance and lawn services, whereas individual owners might be able to perform such tasks themselves. However, these broad categories are consistent with the holding in Knight; in that case, the Supreme Court expressly rejected the trustee's argument that costs should be deducted based on "causation" and fully deductible if required by the trustee's fiduciary duties. Instead, and consistent with the Supreme Court's holding in Knight, because

these are costs that are commonly incurred by individuals, the regulations provide that they are all subject to the 2-percent floor.

Tax Preparation Fees. The regulations further provide in Treas. Reg. § 1.67-4(b)(3) that tax preparation fees included in an exclusive list are not subject to the 2-percent floor. The regulations provide that costs relating to "all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns" are not subject to the 2-percent floor, whereas the costs of preparing "all other tax returns (for example, gift tax returns)" are subject to the 2-percent floor.

The regulations' taxonomy of these categories is, on its face, clear, and at least simple and straightforward in application. However, these categories may not hew closely to the rules articulated by Knight and by the statute. As the American Bankers Association noted in its May 30, 2014, letter to the Commissioner of Internal Revenue, this expressly exhaustive list of returns that are not subject to the 2-percent floor appears to leave out at least two examples of tax-related expenses that would not be incurred if the property were not held in a trust or estate. First, the ABA notes that the list does not exempt the fiduciary's work relating to tax payments or information reporting to a foreign government that imposes wealth and income taxes on foreign tax-resident beneficiaries of domestic trusts. Unless such costs related to foreign taxes would fit into the category of "all … estate tax returns," then such costs would fall under "other tax returns" that do not fit into any specific category in the regulations, and such costs would apparently be subject to the 2-percent floor.

Second, the ABA also notes that the regulations expressly do not exempt from the 2-percent floor the preparation of gift tax returns, even though an executor's duties may require the preparation and filing of past unfiled gift tax returns. It is true that an executor may also be required to file past, unfiled individual income tax returns as part of the executor's duties, and yet those returns certainly would have been (or, perhaps, *should* have been) prepared by a hypothetical individual. Unlike most income tax returns, however, the failure to file gift tax returns that only use the donor's unified credit and do not require the payment of gift tax usually does not result in penalties or interest, and the unique continuity of gift tax returns with the estate tax return makes it hard to understand different treatment for those returns.

Similarly, the list of returns that are not subject to the 2-percent floor may also be inconsistent with the principles underlying the statute. For example, a decedent's final income tax return is expressly included in the regulation as a cost that is not subject to the 2-perceent floor. Still, such a return relates to an individual and presumably would be due for all individuals, even if no executor is appointed. It is not self-evident why all such returns would be exempt from the 2-percent floor, without some threshold determination of whether the preparation of that return related to the decedent's estate or trust, even though final individual income tax returns typically involve splitting a calendar year and making one-time allocations between the decedent's final return and the estate's initial return. Indeed, a harsh view of this exception might have considered the fact that even a fiduciary income tax return often involves much of the same collection and presentation of information as an individual income tax return. Nevertheless, the rule that all fiduciary income tax returns and all final individual income tax returns are exempt from the 2-percent floor is appropriately favorable to taxpayers.

Investment Advisory Fees. Treas. Reg. § 1.67-4(b)(4) provides guidance and examples related to "investment advisory fees" incurred by the estate or trust, and is already the subject of much discussion.

This subparagraph provides that fees for investment advice are typically subject to the 2-percent floor, but the regulations note that "certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor" are not subject to the 2-percent floor. The regulations provide that the amount of the fee that would be charged to the individual is subject to the 2-percent floor, while only the additional fee is not subject to the 2-percent floor.

The regulations give the following two scenarios in which such a "special, additional charge" would not be subject to the 2-percent floor: (i) a special, additional charge "added solely because the investment advice is rendered to a trust or estate," *or* (ii) a special, additional charge "attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen) such that a reasonable comparison with individual investors would be improper."

Taking the second category first, this requirement that the fees require "specialized" balancing has already sparked controversy. It is not clear why the regulations would refuse to recognize a trust or estate's need for the "usual balancing" of interests between current and remainder beneficiaries. In a prior review of the proposed regulations, Ronald D. Aucutt of McGuireWoods LLP noted that "[t]he fact that the 'ordinary taxpayer' has no need for 'balancing of the interests of various parties' will not be lost on fiduciaries and commentators, who will notice that the bar has been subtly raised."

Whatever its merits, this language in the regulations appears to be driven by the language of the Knight opinion. In that case, the trustee had engaged an investment advisor to comply with his fiduciary duties under Connecticut's Uniform Prudent Investor Act, which required a trustee to follow the "prudent investor rule." The Supreme Court first noted that the statute did not apply a different standard to trustees, in that it did not require a trustee to follow a "prudent trustee" rule. The Supreme Court further noted that in other cases, it is "conceivable" that a trust might "require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper" (emphasis added). Because the trust in Knight apparently required such balancing between different beneficial interests, as do most trusts with more than one beneficiary, the Supreme Court therefore implied that such balancing was not sufficiently "specialized" to cause the 2-percent floor to not apply.

One might justify this provision of the regulations by noting that a trustee's need to invest to protect the interests of both current beneficiaries and remainder beneficiaries may be similar to the balancing of income generation and principal conservation. An investment strategy that balances income and principal is regularly recommended by an investment advisor, and thus it may not warrant any special treatment when undertaken for the express purpose of balancing the needs of two classes of beneficiaries.

This reference to "unusual" investment objectives and "specialized" balancing will therefore require substantial further consideration by fiduciaries and investment advisors.

As for the first category of this clause regarding investment advisory fees, which apparently allows for a full deduction if the charge is "added solely because the investment advice is rendered to a trust or estate," it is unclear the extent to which the IRS would allow a full deduction of a fee merely because an investment advisory firm included such a fee on its itemized fee schedule for trusts and estates, and not for individuals. As noted above, the Supreme Court in Knight rejected a simple "causation" test, which would have exempted expenses from the 2-percent floor merely if they were incurred by a trustee in the course of the trustee's duties. One imagines that the IRS would also be skeptical of a trustee's attempt to serve its fiduciary clients by classifying a portion of its fee as required for trusts and estates.

Again, whatever its merits, this language was taken from the opinion in Knight. In that case, the Supreme Court noted that some trust-related investment advisory fees may be fully deductible "if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts," but that in the case of Knight there was nothing to suggest that the advisor "charged the Trustee anything extra, or treated the Trust any differently than it would have treated an individual with similar objectives, because of the Trustee's fiduciary obligations."

It is conceivable, then, that the regulations would allow an investment firm's automatic charge to a trust or estate to be not subject to the 2-percent floor. In fact, such a charge could be a stand-in for the need of the investment firm to balance the needs of income and remainder beneficiaries, even though a fee would not be fully deductible if it were cast in those terms, rather than as an automatic increase in the fee.

In any event, we will likely see fiduciaries develop a series of protocols for distinguishing between trusts with "usual" successive interests, and those with more sophisticated balancing needs that would be exempt from the 2-percent floor.

Appraisal Fees. Treas. Reg. § 1.67-4(b)(5), regarding the deductibility of expenses related to certain appraisals, again sets out an apparently exhaustive list of appraisals that would not be subject to the 2-percent floor, while any other appraisals are not exempted. This clause provides that fees are not subject to the 2-percent floor if incurred to determine date of death values, to determine values for purposes of making distributions, or as otherwise required to prepare the estate or trust's tax returns or generation-skipping transfer tax return.

Certain Fiduciary Fees. The regulations also exempt from the 2-percent floor certain minor fiduciary fees and costs, such as probate fees, fiduciary bond premiums and legal publication costs. These are found in Treas. Reg. § 1.67-4(b)(6).

Bundled Fees

Treas. Reg. § 1.67-4(c) provides a separate set of rules for estates and trusts that pay a single fee, commission or other expense that includes costs that would be subject to the 2-percent floor and

costs that would not. This rule would apply not only to a fiduciary's single commission for fiduciary services, but also to an attorney's or accountant's single fee for advice rendered to such fiduciary.

In the case of such a single fee, commission or other expense, such fee "must be allocated" between costs that are subject to the 2-percent floor and those that are not. The regulations allow any "reasonable" method for such allocation and include the following set of non-exclusive factors that "may" be considered in making such a reasonable allocation: (i) the percentage of the value of the corpus subject to investment advice; (ii) whether a third party advisor would have charged a comparable fee for similar advisory services; and (iii) the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice versus other fiduciary functions.

Notably, if a bundled fee is not computed on an hourly basis, then the regulations provide that only the portion of the fee that is "attributable to investment advice" is subject to the 2-percent floor, and the remaining portion is not. Curiously, because "out-of-pocket" payments to third parties for investment advice are strictly subject to the 2-percent floor under the regulations, the investment advice component the regulations appear to target is in effect advice that a trustee, presumably a corporate trustee, would give to itself. Although this anomaly in the proposed regulations was pointed out in specific public comments, the Treasury Department chose to stick with this idiom, and it would be hard to argue that its intent is not clear.

Treas. Reg. § 1.67-4(c)(2) states that in the case of a non-hourly bundled fee, investment advice is "subject" to the 2-percent floor, and the remainder is "not subject" to the 2-percent floor.

However, this unbundling of non-hourly fees probably also involves a second step. This reference to investment advice being "subject" to the 2-percent floor may only mean that the investment advice portion is "subject" to the rules in subsection (b) regarding applicability of the 2-percent floor. Thus, the fiduciary would unbundle the non-hourly fee in two steps: first, the fiduciary would separate investment from non-investment services, under Treas. Reg. § 1.67-4(c)(2), and would treat the non-investment services as not subject to the 2-percent floor; and second, the fiduciary would separate out that portion of the investment services that is "commonly or customarily" incurred by an individual, from that portion that is particular to a trust or estate, under Treas. Reg. § 1.67-4(b)(4), and would treat the portion that is particular to a trust or estate as also not subject to the 2-percent floor.

As has been stated by McGuireWoods LLP partner Ronald D. Aucutt to the IRS in his public comments on the proposed regulations**,** subjecting estates and non-grantor trusts at all to the 2-percent floor is so contrary to the simplification Congress explicitly intended when it enacted Section 67 that it seems misguided and imprudent. The final regulations remain detached from the statutory objectives and are disappointing. Yet, particularly with regard to the unbundling requirement, the writers of the regulations do not appear to have been oblivious to the vexing administrative burdens. Treas. Reg. § 1.67-4(c)(1) requires unbundling "except to the extent provided otherwise by guidance published in the Internal Revenue Bulletin." This leaves the door open to the provision of expanded exceptions, safe harbors, or other relief that the writers might have sensed is needed but were not able to complete in time to give fiduciaries the almost

eight months of time for implementation that the adjusted effective date provides, and it allows that relief to be published without the formality and delay of an amendment of the regulations.

Conclusion

The postponement of the applicability of these final regulations under Section 67(e) will allow fiduciaries to begin to apply a single set of rules to deductions for trusts and estates on January 1, 2015. As noted above, it is no easy task to develop the best protocols for determining which costs will be subject to the 2-percent floor and which costs will not, and for determining how to unbundle and allocate fees between the two. In particular, fiduciaries will continue to spend the latter half of 2014 developing procedures to determine how best to address investment-related expenses, whether or not those expenses are bundled into unitary fees.

67. Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (2014)

Tax Court provides possible guidance on application of 3.8 percent Medicare Surtax to income of a trust derived from a trade or business

Frank Aragona created the Frank Aragona Trust under Michigan law for the benefit of his five children. The Trust owned rental real estate properties and engaged in other real estate activities, including real estate development. The Trust primarily operated its rental real estate activity through a wholly owned limited liability company, Holiday Enterprises, LLC. The Trust's other real estate activities were conducted through several separate entities, some wholly owned and some in which the Trust owned a majority interest.

Following the settlor's death, his five children and an independent trustee served as co-trustees of the Trust. Three of the children-trustees worked as full-time employees of the LLC, while the remaining two children-trustees were uninvolved in the trust's real estate business. The LLC employed several others who worked as leasing agents, maintenance workers, and accountants to aid in operating the rental real estate business. Finally, two of the three children who served as both trustees of the Trust and employees of the Trust-owned LLC also co-owned minority interests in several of the real estate investments.

In 2005 and 2006, taking the position that the Trust participated in the its real estate business activity on a "regular, substantial and continuous basis," the trustees claimed losses, treating the rental real estate activity as non-passive activity, and carried those losses back to adjust prior tax years. The IRS took a contrary position, and in a notice of deficiency, treated the Trust's rental real estate activity as passive activity.

The primary issues before the Tax Court were: (1) whether the Trust could qualify for treatment as a "real estate professional" and deduct rental real estate losses, and (2) whether the Trust materially participated in the real estate business through the activities of its trustees and/or employees. The Taxpayer ultimately prevailed on both issues, with the Tax Court holding that a trust could not only qualify for the real estate professional exception, but that the Trust materially participated through the actions of its trustees.

Under Section 469(c)(2), rental real estate activity is deemed to be passive unless the taxpayer qualifies as a "real estate professional." Pursuant to Section 469(c)(7)(B), if (i) more than one-half of the taxpayer's personal services are performed in real property trades or businesses in which the taxpayer materially participates, and (ii) such taxpayer performs more than 750 hours of services during the taxable year in those real property trades or businesses, the taxpayer will be considered a "real estate professional," and can therefore avoid passive activity treatment, and use losses or credits against non-passive income generated by such activities.

In Aragona, the IRS argued that a trust could not qualify for treatment as a real estate professional because a trust is incapable of performing personal services. Citing Treas. Reg. § 1.469-9(b)(4) and the legislative history surrounding Section 469(c)(7), which only describes a real estate professional in the context of an individual and a closely-held C Corporation, the IRS submitted that trusts, as an entire category of taxpayer, were not eligible for treatment as a real estate professional.

The Tax Court ultimately rejected the Service's argument, finding that the nature of the test under Section 469(c)(7)(B), including the performance of personal services, could be met by trustees managing assets for the Trust's beneficiaries just the same as an individual taxpayer manages assets for his or her own benefit. In addressing the legislative history, the Tax Court sided with the taxpayer, finding the examples relating to individuals and closely-held C corporations set out in and legislative history were merely illustrative, rather than exclusionary.

As a fallback position, the IRS argued that even if some trusts could perform personal services, the Trust did not qualify as a real estate professional because the trustees did not materially participate in the Trust's real estate rental businesses. The Service maintained its fiduciary capacity argument, asserting that only the activities of the trustees acting in a fiduciary role could be considered for purposes of material participation, and the activities of any trustee acting as an employee or co-owner, as well as the activities of all non-trustee employees, must be disregarded.

The Trust, citing Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003), argued that the activities of all those acting on behalf of the Trust should be considered in determining whether the Trust materially participated. In Carter, the trust owned a 15,000-acre cattle ranch, which was operated by a ranch manager and run by ranch hands hired by the trustee. The trustee did not partake in the daily operations of the ranch and was primarily involved in reviewing financial records and making financial decisions on behalf of the trust. The trustee reported the activity on the ranch as an active trade or business of the trust, and the IRS responded by re-classifying the losses arising from the ranch activity as passive losses. The district court in Carter found for the taxpayer, holding that material participation could be determined by reference to all persons acting on behalf of the trust. The district court reasoned that measuring the trust's participation solely by reference to the trustee's actions "finds no support within the plain meaning of the statute," and the district court found it unnecessary to delve into the "snippet of legislative history the Service supplied" where the statutory language was clear.

In countering the Service's fiduciary capacity argument in Aragona, the Trust turned to Michigan law under which a trustee cannot disregard his or her fiduciary duties even while simultaneously acting in another capacity. Relying on this precedent, the Trust argued that it was impossible for the trustees of the Trust to remove their fiduciary "hat," even while carrying out multiple roles relating to the Trust owned businesses.

Persuaded by the Taxpayer's argument, the Tax Court found "the activities of the trustees—including their activities as employees of Holiday Enterprises, LLC—should be considered in determining whether the trust materially participated in its real-estate operations." The Tax Court rejected the IRS's narrow view of what activities comprise material participation in the context of a trust.

The Tax Court was not persuaded by the Service's argument that some of the activities of the two trustees, who also held minority ownership interests in several of the Trust's real estate holdings, should be disregarded for purposes of determining whether the Trust materially participated. The Tax Court gave four reasons for including the activities of these two trustees: (1) the trustees' combined ownership interest were not a majority interest, (2) the trustees' combined ownership interest did not exceed that of the Trust, (3) the trustees' interests as co-owners were compatible with the Trust's goals for success in those jointly held enterprises, and (4) the trustees were involved in managing the day-to-day operations of the Trust's various real-estate businesses. The court's analysis rests on the facts of the case and falls short of laying out a specific quantitative test for material participation when a trustee has multiple roles in a business.

While this case does not directly concern the application of the Medicare Surtax, the Tax Court's holding nevertheless interprets the material participation requirements under Section 469 as applied to a trust, and therefore provides fiduciaries and beneficiaries with a possible guide to what really matters for material participation of trusts.

For trusts, Section 1411(a)(2) imposes the 3.8 percent surtax on the lesser of: (A) the undistributed net investment income for such taxable year, or (B) the excess (if any) of (i) the adjusted gross income for such taxable year, over (ii) the dollar amount at which the highest tax bracket in Section 1(e) begins for the tax year in question. This means the Medicare Surtax is imposed on trusts with undistributed net investment income and adjusted gross income over a certain threshold ($11,950 for 2013 and $12,150 for 2014).

Certain types of income are specifically excluded from the definition of net investment income, including non-passive trade or business income. Section 1411 invokes Section 469 to determine whether income derived from a trade or business is considered passive or non-passive income. Pursuant to Section 469, income is considered non-passive if the taxpayer "materially participates" in the activity generating such income. Section 469(h)(1) provides that a taxpayer is treated as materially participating in an activity if the taxpayer is involved in the operations of the activity on a "regular, continuous and substantial basis."

While individuals may use one of seven quantitative tests outlined in the Treasury Regulations to establish material participation and avoid passive income treatment, no legislative or regulatory guidance is currently available addressing how a trust can meet the material participation

standard. Moreover, there is but one line in the Senate Report accompanying the Tax Reform Act of 1986, which states that a trust "is treated as materially participating in an activity… if an executor or fiduciary, in his capacity as such, is so participating." S. REP. NO. 99-313, at 735 (1986). Which activities of a fiduciary will count toward meeting the material participation standard and in what capacity those activities are so performed, however, is a point of contention between taxpayers and the Service.

After the district court's decision in Carter, the IRS consistently rejected the district court's rationale, and instead has maintained that only the activities of a trustee, acting in the trustee's fiduciary capacity, may be considered in analyzing whether a trust materially participates in an activity. In two Technical Advice Memoranda, in Letter Ruling 200733023 (Aug. 17, 2007), and Letter Ruling 201317010 (Apr. 26, 2013), issued since Carter, the Service further expanded its "fiduciary capacity" argument, but held firm to its position. Now, in Aragona, the Service has, as in Carter, lost in the courts.

68. Wyly v. United States, 2014 U.S. Dist. LEXIS 135671 (September 24, 2014)

Court holds that imputed actual control, but not legal control, over offshore trusts causes offshore trusts to be subject to grantor trust rules which in turn required reporting to Securities and Exchange Commission

In a civil enforcement action against Samuel Wyly and the estate of his brother, Charles Wyly, the Securities and Exchange Commission (SEC) alleged ten securities violations arising from tax planning in which the Wylys established a group of offshore trusts and subsidiary entities in the Isle of Man, used those offshore entities to trade in the shares of four public companies on whose boards the Wylys sat, and failed to properly disclose their beneficial ownership of that stock. The liabilities and remedies phases of the trial were split. In a jury trial on liability on nine of the ten claims, the jury returned a verdict against both Sam and Charles Wyly on all nine claims. This decision in this case was in the subsequent remedies phase. The SEC sought an order of disgorgement against the Wylys in the amount of $619,298,512.45. This figure included the amount of taxes that the Wylys avoided when the stock in the Isle of Man trusts was sold. The SEC also sought a civil penalty and injunctive relief.

Between 1992 and 1996, Sam and Charles Wyly created a number of Isle of Man trusts which were treated as separate entities for income tax purposes and were intended to avoid U.S. income taxation. The Wylys' family attorney, the Chief Financial Officer of the Wyly Family Office, and the CFO of a related trust company served as the protectors of the Isle of Man trusts. The trust protectors conveyed the Wylys' investment recommendations to the trust management companies administering the Isle of Man trusts. All the investment transactions were based on the Wylys' recommendations and the Isle of Man trustees never declined to follow a Wyly recommendation.

Between 1992 and 1999, Sam and Charles Wyly sold or transferred to the Isle of Man trusts or companies, stock options in four publicly traded entities in exchange for private annuities while simultaneously disclaiming beneficial ownership over the securities thereby claiming there was no need for public filings with the SEC with respect to the four companies. Between 1995 and

2005, the Isle of Man trusts and companies exercised these options and warrants, separately acquired options and stock in all four companies, and sold the shares without filing disclosures with the SEC.

The offshore system was created with the advice of a Louisiana lawyer who lectured extensively on the use of foreign trusts as a method of asset protection and tax deferral. According to the court, the Wylys wished to avoid any disclosure of their control of the stocks in order to maintain the tax free status of these trusts, including income from transactions in the securities of the four public companies. The court noted that it was logical to draw the inference that making misleading statements in SEC filings, or not making SEC filings at all, was part of the Wylys' plan to maintain the appearance of their separation and independence from the foreign trusts.

The offshore trusts were explicitly set up as non-grantor trusts. Under the terms of the trusts to avoid U.S. income taxation, no United States beneficiary could receive a distribution from the trusts until two years after the death of the respective settlors. However, the SEC argued that the Isle of Man trusts were grantor trusts under Section 674(a) because the Wylys retained the ability to affect the beneficial enjoyment of the trusts. The SEC also argued that the Isle of Man trusts were foreign trusts under Section 679 because the transfer of property to the trusts was not made for fair market value.

The trusts were administered by professional asset management companies located in the Isle of Man. The trustees were selected by the Wylys or the trust protectors. The protectors, all of whom the court saw as agents of the Wylys, had the authority to remove and replace trustees. The protectors also transmitted the Wylys' investment recommendations to the trustees. The Wylys presented no evidence of an investment made by the Isle of Man trusts that did not originate with the Wylys' recommendations. No Isle of Man trustee rejected a Wyly recommendation. There were also several transactions in which the Wylys bypassed the trustees all together. Some of the Wylys' recommendations had nothing to do with the securities. Among the many personal purchases, loans, and investments the Wylys directed the Isle of Man trustees to make, were business as for Wyly children and family members, real estate, artwork, jewelry, and collectibles.

The court found that the Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. Thus, Section 674(a) applied to make the Isle of Man trusts grantor trusts. The Wylys tried to argue that the trust fell within the shelter of the independent trustee exception of Section 674(c). The court disagreed finding that the trustees were not independent. As a result, because the Wylys and their family members were beneficiaries, the Isle of Man trustees were distributing income for the benefit of the beneficiaries at the direction of the grantors and Section 674 applied. Consequently, the Wylys owed income taxes from the trading profits on the sale of the securities. The court declined to tax those sales at the ordinary income tax rate. Instead the court applied either the ordinary income tax rate or the capital gains tax rate for the appropriate year and transaction. This resulted in disgorgement of approximately $112 million for Sam Wyly and $59 million for Charles Wyly.

In making this determination that the Isle of Man trusts were grantor trusts under Section 674, the court disagreed that the Wylys did not share in the power to distribute, apportion or allocate

income or corpus because under the trust documents those powers fell solely to the trustees. Instead, the court noted that "such a rigid construction is unwarranted." It could not be squared with a black letter principle that "tax law deals with economic realities, not legal abstractions." It then cited Professor Robert Danforth, the defendant's expert, who wrote in a treatise "it would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person." The court then noted that the Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their wishes and the trustees did exactly that.

This is a case in which there are bad facts. This case does show that a court might attribute the powers of the trustees or the trust protectors to the grantor if sufficient distance is not maintained.

69. Linn v. Department of Revenue, 2013 IL App. 4th 121055 (December 18, 2013)

Illinois Appellate Court finds that income taxation of irrevocable inter vivos trust created by Illinois resident as a resident trust violated due process clauses

In 1961, A.N. Pritzker established 20 separate irrevocable trusts with Meyer Goldman as trustee. At that time, both Pritzker and Goldman were residents of Illinois and the trust assets were held in Illinois. The provisions of each trust allowed the trustee a limited power to distribute all or part of the trust corpus to different trustees to be held in further trust for the benefit of the beneficiaries of each of the 20 trusts. The trustee also had the power in its discretion to distribute the whole or part of the trust corpus to a beneficiary after the beneficiary attained 30 years of age. The 1961 agreement stated the trust was to be construed and administered and the validity of the trust was to be determined in accordance with Illinois law. One of the trusts was for the benefit of Pritzker's daughter Linda, and was named the "Linda Trust."

A.N. Pritzker died in 1986 as an Illinois resident and his estate was probated in Illinois. At some point, Thomas Pritzker of Illinois, Marshall Eisenberg of Illinois and Arnold Weber succeeded Goldman as trustees of the Linda Trust and were the trustees of the Linda Trust in 2002. On January 2, 2002, the trustees of the Linda Trust exercised the limited power of appointment and irrevocably distributed assets from the Linda Trust to plaintiff, Lewis Linn, trustee of the "Autonomy Trust 3" for the exclusive benefit of Linda.

Along with the exercise of the power of appointment, the trustees of the Linda Trust entered into a trust agreement that created the Autonomy Trust 3. Jay Robert Pritzker of Illinois was initially named as protector of the trust but was replaced as protector of the trust in December 2002 by a Connecticut resident. The Autonomy Trust 3 stated that the trust was to be construed and regulated under Texas law except that the terms "income," "principal," and "power of appointment" and the provisions relating thereto were to be interpreted under the laws of the State of Illinois.

In February 2004, the trust was reformed to strike the language referring to Illinois law, leaving the trust to be construed and regulated only by Texas law.

By 2006, Linda, her children and the other beneficiaries of the Autonomy Trust 3 were not Illinois residents. The trustee resided in Texas and the trust was administered in Texas. The trust had no assets in Illinois.

In April 2007, the trust filed a 2006 non-resident Illinois income tax return showing no income from Illinois sources and no tax due. The Illinois Department of Revenue audited the return and assessed a deficiency liability of $2,729 saying that the trust was an Illinois trust and subject to Illinois income tax. 35 ILCS § 5/1501(a)(20)(D) defines "resident" to include an irrevocable trust, the grantor of which was domiciled in this state at the time such trust became irrevocable.

The trustee brought an action in Illinois court against the Department of Revenue and both the trustee and the Department of Revenue filed motions for summary judgment and the trial court granted the Department of Revenue's motion for summary judgment. The trial court noted that the 1961 trust agreement provided that Illinois law was to govern the trust and that was a sufficient contact to satisfy the Due Process and Commerce Clauses of the United States Constitution.

At the appellate court, the parties agreed that the case could not be resolved on a non-Constitutional basis because of the provision of Illinois law that defines a resident trust as an irrevocable trust, the grantor of which was domiciled in Illinois at the time such trust became irrevocable. The court first looked to see whether the Due Process Clause was violated. It stated that for a tax to comply with the Due Process Clause there must be a minimum connection between the state and the person, property, and transaction it seeks to tax and the income attributable to the state for tax purposes must be rationally related to values connected with the taxing state.

The court rejected the Department of Revenue's allegations that connections did exist because the trust owed its existence to Illinois and Illinois provided the Autonomy Trust 3's trustee and beneficiary with panoply of legal benefits and opportunities. Both parties cited the Connecticut Supreme Court's decision in Chase Manhattan Bank v. Gavin, 249 Conn. 172 (1999), which involved four testamentary trusts and one inter vivos trust. The court only looked at the inter vivos trust in Gavin since Autonomy Trust 3 was an inter vivos trust. The Illinois court noted that the critical link in Gavin between Connecticut and the undistributed income sought to be taxed was the fact that the inter vivos trust's non-contingent beneficiary was a Connecticut resident during the tax year in question. That was not the situation here. It noted that an irrevocable inter vivos trust does not owe its existence to the laws and courts of the state of the grantor in the same way that the testamentary trust does and does not have the same permanent ties. It found that no Illinois probate court had jurisdiction over the trust unlike those trusts in the testamentary trust cases. It also found that the trust received the benefits and protections of Texas law and not Illinois law. It then found that the trust met none of the factors that would give Illinois personal jurisdiction over the trust in litigation which are: the provisions of the trust instrument, the residence of the trustees, the residence of the beneficiaries, the location of the trust assets, and the location where the business of the trust is to be conducted.

As a result, there were insufficient contacts between Illinois and the trust to satisfy the Due Process Clause. Since the Autonomy Trust failed to meet the requirements for Illinois income taxation provided by the Due Process Clause, the court did not have to address the Commerce Clause arguments which require more substantial contacts.

70. United States v. Stiles, _____ F. Supp. 2d ___ (W.D. Pa. 2014)

Court grants government's summary judgment motion to foreclose on lien for payment of income tax liability

Julia Stiles died in 2002. Her son, David Stiles, was appointed executor of her estate. The income tax return for the estate was not filed until June 2008. The IRS then assessed taxes, interest and penalties against the estate in the amount of $2,093,091. The estate also owed $12,936 to the Register of Wills and $110,635 to the Delaware Division of Revenue. The Estate's primary assets consisted of real estate in Wilmington, Delaware and an investment account that, at the time of Julia Stiles death was worth $2,303,547. The real property in Delaware was sold in August 2002 for $379,000 and the proceeds were distributed shortly after the sale. Between 2002 and 2005, David Stiles distributed approximately $775,000 from the estate to himself and $425,000 to each of his two sisters. In the beginning of April 2008, the estate's investment account was worth $1,787,660. In April 2008, Stiles distributed $110,635 to the Delaware Division of Revenue. The IRS stated that as of March 31, 2014, the estate owed the IRS $71,762. In addition, interest had been assessed as well as penalties for failure to timely pay the tax, for failure to make required estimated tax payments, and accuracy related penalty.

In 2010, the U.S. filed a federal tax lien against Stiles and his wife on property in Washington County, Pennsylvania with respect to the income tax liabilities for 2007 and 2008. The government then filed for summary judgment with respect to the enforcement of its lien. The court noted that Stiles, who had representation, failed to file a responsive statement of material facts. As a result, Stiles acquiesced to the record presented by the government. To survive summary judgment, Stiles had the duty to demonstrate the existence of a genuine issue for trial or submit an affidavit requesting additional time for discovery.

The government argued that Stiles and his sister were personally liable for depleting the estate before providing for the payment of the taxes owed by the estate. The government alleged that the estate held assets worth approximately $2.7 million at the time of Julia Stiles' death. The government also noted that after David Stiles sold the Delaware real estate property and made distributions from the investment account, the estate's liabilities exceeded its assets. Stiles admitted through testimony that he knew about the estate's federal tax liability and that estate taxes and yearly fiduciary income taxes would have to be paid. Stiles tried to argue that he relied upon counsel in making the distributions to himself and the sisters. The court noted that relying on the poor advice from attorneys is not a defense. The court noted that a tax lien upon all the Stiles property arose when he neglected or refused to pay the assessed taxes. The government asked that its lien upon property in Washington County be foreclosed upon and that the real property be sold to pay the outstanding liabilities which the court granted.

71. <u>Belmont v. Commissioner</u>, 144 T.C. No. 6 (2015)

Estate is not entitled to income tax deduction under Section 642(c)(2)

Decedent's will directed that the residue of her estate, which included income in respect to the decedent, be left to charity. The estate took a charitable contribution deduction under Section 642(c)(2) on its federal income tax return claiming that it had permanently set aside an amount of its gross income for charity.

At the time of her death, Decedent owned a condominium in which her brother resided. During the protract administration of the estate, the brother took a variety of legal actions and asserted a life tenancy interest in the condominium. The brother was subsequently awarded a life tenancy in the condominium. Because of the cost of litigation over the condominium, the estate lacked sufficient funds to pay the amount previously deducted as a charitable contribution.

The court found that under Section 642(c)(2), any part of the gross income of an estate which pursuant to the terms of the governing instrument is permanently set aside during the taxable year for charitable purposes shall be allowed as an income tax deduction to the estate on the fiduciary income tax return.

Treas. Reg. § 1.642(c)-2(d) provides that no amount will be considered permanently set aside for charity unless under the terms of the governing instrument and the circumstances of a particular case, the possibility that the amount set aside will not be devoted to such purpose or use is so remote as to be negligible. The possibility that the costs involved in a dispute over the condominium would cause the estate to invade the amount set aside for charity was not "so remote as to be negligible" as required under the regulations. As a result, the estate did not "permanently set aside" the charitable contribution amount as required under Section 642(c)(2) and, therefore, was not entitled to the income tax charitable deduction.

OTHER ITEMS OF INTEREST

72. <u>Estate of Woodbury</u>, T.C. Memo 2014-66

Tax Court rules that estate failed to make Section 6166 Election to pay tax in installments

Decedent died on September 27, 2006. Decedent's federal estate tax return had a filing date of June 27, 2007. Before that date, the estate filed a Form 4768 (Request for an Extension of Time to File a Return and/or Pay Tax) to request an extension of time to file the estate tax return and was granted a six-month extension of time to December 27, 2007. In its extension request, the estate included a letter listing the decedent's name and taxpayer identification number, informing the IRS that the estate intended to make the Section 6166 election to pay the part of the estate tax attributable to the inclusion of closely business interests in the estate in installments when the estate tax return was filed, and stating that the estate had paid non-deferrable tax of $9,500,000 and estimated the tax to be paid in installments under Section 6166 to be $10,000,000. The estate did not include any specific information regarding the properties that constituted the closely-held business or a list of the properties.

On December 31, 2007, the IRS received a second Form 4768 from the estate requesting an additional six-month extension of time to file the estate tax return. The extension request also included a letter indicating that the estate planned to make the Section 6166 election. On February 6, 2008, IRS denied the second application for extension. The IRS stated that, by law, it was unable to grant an additional extension of time for filing the return. The estate filed its federal estate tax return on June 1, 2010.

The estate and the IRS filed cross motions for summary judgment on the issues of whether the estate had made a Section 6166 election or, in the alternative, had substantially complied with the requirements for making a Section 6166 election. The court granted the IRS's summary judgment request. It noted that the estate had not complied with Section 6166 because it had not provided the required information with its Request for an Extension to constitute a valid notice of election. This information is:

1. The decedent's name and taxpayer identification number.
2. The amount of taxes to be paid in installments.
3. The date selected for the payment of the first installment.
4. The number of annual installments including the first installment.
5. The properties shown on the estate tax return that constitute the closely-held business.
6. The facts that show that the estate qualified for installment payments.

These requirements are found in Treas. Reg. § 20.6166-1(b). The court found that the estate failed to comply or to substantially comply with the requirements in the regulations.

The estate had also requested that, if the doctrine of substantial compliance did not apply, the court should order the IRS to allow the estate an equivalent amount of time to pay the remaining estate tax and interest. The court noted that it lacked jurisdiction to consider the alternative request for relief. It could only make a declaratory judgment regarding whether a Section 6166 election could be made or whether the extension of time for the payment of tax had ceased to apply. In this situation the court decided that the estate was not entitled to the 6166 election.

73. Estate of Thouron v. United States, 752 F.3d 311 (3d Cir. 2014)

Third Circuit vacates district court decision in which it denied estate a refund of a late payment penalty, because the estate might be able to establish reasonable cause for missing the tax payment deadline

Sir John Thouron, a resident of the United States, died in 2007, leaving a substantial estate of which his two grandchildren were his only heirs. He named Charles H. Norris as executor of his estate. Norris retained Cecil Smith, an experienced tax attorney, to provide tax advice.

The estate's tax return payment was initially due on November 6, 2007. On that day, the estate filed a request for an extension of time to file its return and made a payment of $6.5 million. This turned out to be much less than the estate would ultimately owe. The estate argued that it failed to pay the balance of its liability or, in the alternative, requested an extension of time to pay at least in part, because Smith advised about the possibility of electing to pay a portion of the tax in installments under Section 6166.

The estate timely filed its return in May 2008 and at the same time requested an extension of time to pay. It made no election to defer taxes under Section 6166 because, by then, it had conclusively determined that it did not qualify. The IRS denied as untimely the estate's request for an extension of time to pay and imposed a failure to pay penalty, which the estate appealed administratively. After losing the administrative appeal, the estate filed an appropriate form and paid all outstanding amounts, including a penalty of $999,072. After the IRS failed to respond to a request for refund of that amount, the estate filed in the Eastern District of Pennsylvania and alleged that its failure to pay resulted from reasonable cause. The IRS moved for summary judgment and the District Court granted the motion.

The Circuit Court noted that under Section 6651(a)(2), if a tax is not paid in full by the prescribed due date, a mandatory penalty is assessed of .5% of the amount of such tax if the failure is for not more than one month, with an additional .5% for each additional month or fraction thereof during which such failure continues, up to a maximum of 25%. Section 6651(a)(2) applies "unless it is shown that such failure is due to reasonable cause and not due to willful neglect." The "heavy burden" of showing both elements falls on the taxpayer. United States v. Boyle, 469 U.S. 241 (1985). The estate argued that its reliance on the advice of Smith, a tax expert, was reasonable cause for its failure to pay the full tax liability by the November 2007 deadline. The District Court read the Supreme Court's decision in Boyle to preclude any finding of reasonable cause based on the reliance of an expert or other agent, stating that the Supreme Court had established a bright line rule that the failure to make a timely filing of the tax return is not excused by the taxpayer's reliance on an agent. While Boyle was a late filing case, the District Court adopted the reasoning of the Ninth Circuit in Baccei v. United States, 632 F.3d 1140 (9th Cir. 2011) to conclude that the holding in Boyle applies with equal force to a failure to pay a tax. In this decision, the Circuit Court read Boyle as reaching only the category of cases which find that reliance on another to perform the ministerial tax of filing or paying cannot be reasonable cause for failure to file or pay by the deadline. It noted that there were two other categories that Boyle did not address. In the first, "in reliance on the advice of his or her accountant or attorney, the taxpayer files a return after the actual due date, but within the time the adviser erroneously told him or her it was available." In the second, "an accountant or attorney advises a taxpayer on a matter of tax law."

The Circuit Court found that this was not a case of reliance on another for the ministerial task of filing or paying. Instead, the court said that a taxpayer's reliance on the advice of a tax expert may be reasonable cause for failure to pay by the deadline if the taxpayer can also show either an inability to pay or an undue hardship for paying at the deadline. This creates a genuine disputed material fact. This case is one of the failure of expert advice, not (based on the record) the failure of an agent to complete a task. As a result, the decision of the District Court was vacated and remanded.

74. Specht v. United States, __ F. Supp. 2d ___ (S.D. Ohio 2015)

Court upholds late filing penalties imposed on estate for late filing of an estate tax return when the individual executor relied on attorney suffering from brain cancer

This action arose as a result of the IRS's motion for summary judgment. Virginia Escher passed away in 2008 with an estate worth $12,506,462. Her cousin, Janice Specht, was appointed executor. Specht, then 73, was a high school educated homemaker who had never served previously as an executor, owned no stock, and had never been in an attorney's office. Ms. Specht selected Ms. Escher's attorney, Mary Bachsman, to assist her. Ms. Bachsman had over 50 years of experience in estate planning, but was privately battling brain cancer. According to the court, Ms. Bachsman "deceived" Ms. Specht as to the status of an extension regarding the filing of the estate tax return and the payment of tax. That deception eventually led to malpractice claims and the voluntary relinquishment of Ms. Bachsman's law license. Subsequently Ms. Bachsman was declared incompetent and was subject to a guardianship over her pension and estate.

The estate filed the federal estate tax return and paid the federal estate on January 26, 2011 almost sixteen months after the September 30, 2009 due date. The estate argued that reasonable cause existed for failure to timely file and pay estate taxes because its failure was due to the reliance on the attorney who was entrusted to handle the estate. The IRS maintained that courts have recognized the non-delegable nature of the duty to make timely filings of tax returns and have held that reliance on counsel is insufficient to constitute reasonable cause for the failure to file a return or pay a tax. The IRS imposed penalties and interest of $1,198,261.38.

The estate did not contest that it failed to timely file or pay the estate tax. The only issue was whether the failures were due to "reasonable cause and not due to willful neglect." Under Section 6651(a), the penalties for failure to file a return or failure to pay will not be owed if the taxpayer can establish that the failure is "due to reasonable cause and not due to willful neglect."

In granting the IRS's motion for summary judgment, the district court relied on United States v. Boyle, 469 U.S. 241 (1985). The district court first noted that the Supreme Court in Boyle recognized the distinction between a taxpayer that relied on the erroneous advice of counsel concerning a question of law and a taxpayer who retained an attorney to attend to an unambiguous precisely defined duty to file a return by a certain time. A taxpayer may reasonably rely on advice received from an attorney on a matter of tax law. However, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due.

Although Ms. Specht lacked the sophistication of single handedly completing and filing the estate tax return, no evidence was produced to suggest that she lacked the sophistication to understand the importance of the estate tax return filing deadline or to ensure that the deadline was met.

In addition, the court felt that the late filing and payment resulted from willful neglect. Ms. Specht was aware that the federal tax returned needed to be filed and paid within nine months after Ms. Escher's death, that the tax liability was approximately $6 million, and that the estate

would need to sell UPS stock owned by Ms. Escher that it held to cover the tax liability. She also understood that the deadline was important and that missing the deadline would result in consequences. She also received numerous notices from the probate court that the estate was missing deadlines and that Ms. Bachsman had failed to file a first accounting. In addition, there were letters from another family that had hired Ms. Bachsman informing Ms. Specht that Ms. Bachsman was incompetent and two letters from the Ohio Department of Taxation informing Ms. Specht that the state estate tax return was delinquent.

The court noted that while it was difficult to hold that Ms. Specht was ultimately responsible for Ms. Bachsman's malpractice, that binding precedent required that results. It also noted that in light of Ms. Bachsman's malpractice, the State of Ohio refunded the late filing and payment penalties for Ohio state estate taxes without the estate filing a refund suit. It was unfortunate that the United States did not follow the State of Ohio's lead.

75. Letter Ruling 201423009 (Issued February 27, 2014; released June 6, 2014) and Letter Ruling 201426005 (Issued March 19, 2014; released June 27, 2014)

Purchase of second-to-die and single-life insurance policies by one trust from related trust was not a transfer for value

These are almost identical letter rulings which reach the same conclusions on an identical set of facts. Husband and wife were the grantors of the BA Irrevocable Trusts for federal fiduciary income tax purposes. Each BA Trust owned second-to-die insurance policies on the joint lives of husband and wife and single-life insurance policies on wife's life. The husband was also the sole grantor of the AB Trust which was a grantor trust owned by husband for federal fiduciary income tax purposes. The AB Trust planned to purchase both second-to-die and single-life insurance owned by the BA Trusts.

The Service first looked at the issue of whether the purchase of the life insurance policies would be a transfer for value under Section 101(a)(2). Under Revenue Ruling 85-13, 1985-1 C.B. 184, a transaction cannot be recognized as a sale or exchange if the same person is treated as owning the consideration both before and after the transaction. Revenue Ruling 2007-13, 2007-1 C.B. 685 specifically discusses the consequences of a transfer of a life insurance policy between trusts. Under one of the factual situations discussed in Revenue Ruling 2007-13, when a trust acquires a life insurance contract in exchange for cash from a separate trust and both trusts were treated as grantor trusts owned by the same grantor, the transfer of the life insurance contract between the two grantor trusts that are treated as owned by the same grantor is not a transfer for valuable consideration under Section 101(a)(2). Therefore, the proceeds of the life insurance policies when received by the AB Trust will not be subject to ordinary income tax.

The next issue at which the Service looked was the impact of the transfer of Wife's interest in the BA Trusts of which she was a grantor to the AB Trust of which only Husband was the grantor under Section 1041. Section 1041(a)(1) provides that no gain or loss occurs on the transfer of property to an individual's spouse. Section 1041(b) provides that any transfer of property from an individual to or in trust for the benefit of the spouse will be treated as acquired by the transferee by gift and the basis of the transferee in the property will be the adjusted basis of the

transferor. The Service held that the proposed sale of the policies on Wife's life in the BA Trusts, of which she was a grantor, to the AB Trust in which Husband is the grantor, would be treated as a gift to Husband who would receive a carryover basis in the life insurance contracts.

76. CCA 201429022 (July 18, 2014)

Section 121(d)(11)) applies to recipients of a house from a decedent who died in 2010

Section 121(d)(11) was enacted as part of the 2001 Tax Act to apply beginning in 2010 when the estate tax was scheduled to end with the imposition of a modified carryover basis regime. Beginning in 2010, the exclusion of part of the gain realized on the sale of the principal residence owned by decedent would also apply to the estate of the decedent, any individual who acquired the property from the decedent as a result of decedent's death, and a trust which immediately before the decedent's death was a qualified revocable trust established by the decedent. Section 121(d)(11) was repealed as part of the 2010 Tax Act. The issue addressed in this internal legal memorandum was whether Section 121(d)(11) was still in effect. The memorandum concluded that Section 121(d)(11) is obsolete for most taxpayers. The only exception is in the case of a taxpayer receiving a house from a decedent who died in 2010 for whom the executor of the decedent's estate made an election to opt out of the estate tax. In this situation, taxpayers receiving a principal residence from a 2010 decedent could still apply Section 121(d)(11) to exclude part of the gain on the sale of the principal residence.

77. United States v. Whisenhunt ___ F. Supp. 2d ___ (N.D. Tex 2014)

District Court concludes that estate is liable for unpaid taxes finding that beneficiary's pending claims against the executor and other beneficiaries do not preclude the entry of final judgment for the government

Fred K. Whisenhunt was the executor of the estate of Jacob Kay. As executor, he distributed the assets of the estate before fully paying the federal estate tax owed by the estate. The IRS assessed penalties against the estate. The government initiated this lawsuit regarding the unpaid estate tax, penalties, and interest, which totaled $178,406.41 as of the date of the filing of the case.

In 2012, the government sued the executor in his fiduciary and personal capacity and the beneficiaries in their personal capacities under federal and state law.

Two beneficiaries answered the complaint and filed a third-party complaint against Whisenhunt for breach of fiduciary duty as executor of the estate. No other defendants responded to the government's complaint. A default judgment order was entered against Whisenhunt who was ordered in his capacity as executor and also personally to pay the unpaid estate tax, penalties, and interest.

Subsequently, the government dismissed certain of the claims against all the beneficiaries except John Voelker. Consequently, three of the original six claims remained relating to the foreclosure of federal tax liens, and judgment against the estate beneficiaries under both federal law and Texas law. The government moved for summary judgment against John Voelker, the one

beneficiary against whom two claims were not dismissed. Voelker filed a cross motion for summary judgment. Here, the government moved for final judgments on its claims against Whisenhunt and Voelker and asked the court to find that Whisenhunt was liable both as executor and personally and that Voelker was personally liable for the unpaid estate tax, penalties, and interest, up to the value of his own distribution. Voelker argued that he had outstanding cross and third-party claims against the other beneficiaries and Whisenhunt and that those should be decided before judgment was entered against him. The court found that Voelker's third-party claims against his co-beneficiaries had no bearing on his own liability for the unpaid penalties and tax. The same could be true of Voelker's cross-claims against Whisenhunt in which Voelker alleged that Whisenhunt breached his fiduciary duty. As a result, there was no reason to delay the government from enforcing its judgment.

78. Letter Ruling 201403012 (Issued September 25, 2013; released January 17, 2014)

Pro rata distribution of business properties to a decedent's estate and the subsequent distribution of the property to limited liability companies will not affect estate tax installment payment schedules under Section 6166

Decedent's estate made a Section 6166 election to defer the payment of estate tax attributable to decedent's interest in several closely held general partnerships, limited liability companies, and corporations. Decedent's estate and its partners held certain commercial real estate property interests as tenants in common as nominees for one of the general partnerships called "Business" in the letter ruling.

The partners of Business intended to restructure the business by having Business distribute each of the properties owned by it pro rata to the partners, including decedent's estate. Thereafter, decedent's estate and the other partners would contribute each of their respective interests in one or more of the properties to separate limited liability companies in return for an interest in the limited liability company equal to the value of the property contributed. Each limited liability company would continue the active business previously conducted by Business with respect to that particular property. No withdrawal of money or other property from the closely held business would occur as a result of the proposed transaction.

The estate was concerned that because Business represented more than 50% of the total value of the closely held businesses reported on the estate tax return, the disposition might exceed the 50% threshold which would result in the termination of the Section 6166 extension of time under which the estate could pay. As a result, the estate requested rulings that the transaction would not constitute a distribution, sale, exchange or other disposition of an interest in a closely held business and would not result in the acceleration of the installment payments of federal estate tax provided under Section 6166. The IRS determined that because the transaction would not materially alter the way in which the business was run and the ownership interests of the different owners, because there would be no withdrawal of money or other property from the business, and because decedent's estate would hold the same proportion of ownership interest in each LLC as decedent had held in Business when he died, there would be no acceleration of the payments under Section 6166.

79. <u>Winford v. United States</u>, ___ F.3d ___ (5th Cir. 2014)

Remittance of $136,268 with request for extension of time to file an estate tax return was a payment of estate tax and a subsequently requested refund was barred by the applicable statute of limitations

The Estate of Laura Bishop sued the United States alleging that it was entitled to a refund of $136,268 remitted to the Internal Revenue Service before the assessment of its estate tax liability. The Estate and the United States filed motions for summary judgment. The district court granted the government's motion, concluding that the remittance was a payment and thus the refund was barred by the applicable statute of limitations.

Bishop, who died on October 29, 2002, left a will in which she named her granddaughter, Winford, and two others as co-executors of the estate. The estate was unable to file the federal estate tax return on time because of litigation spanning three states. According to Winford, while the estate could accurately determine its assets, it could not definitely determine its liabilities. As a result, Winford filed an extension of time to file a return and attached a check for $230,884. In addition, Winford attached a partially completed Form 706 on which she provided an "estimated tax" based on the assets and liabilities known at the time of the submission. Neither the partially completed form nor the check specified whether the remittance was a "payment" or a "deposit". It was characterized as an "estimated payment" on the Explanation of Extension Request that was submitted with the application for extension of time to file a return. The IRS posted the remittance as a payment on July 29, 2003.

In 2008, the estate's litigation was resolved and Winford filed the estate tax return in July 2009. The litigation expenses totaled $285,000. After deducting the litigation costs, the federal estate tax return listed the amount of the estate tax owed at $94,598. In subtracting the liability from the original remittance amount, the estate claimed entitlement to a credit of $136,268. The IRS disallowed the claim, finding that it was submitted outside of the statutory three-year limitation period. Winford appealed and did not dispute that if the remittance was a payment, the estate's claim for a refund was time barred by the statutory limitation period prescribed in Section 6511(b)(2)(A). Instead, she claimed that the remittance was a deposit to which the statute of limitations would not apply.

The government moved for summary judgment, and the district court used a facts and circumstances test developed by the circuit courts using Rosenman v. United States, 323 U.S. 658 (1945). The district court found that the estate's good faith approximation of its tax liability, failure to contest its tax liability, failure to indicate that the remittance was a deposit, and submission of its remittance with its request for an extension weighed in favor of concluding the remittance was a payment. As a result, the district court found that the estate's claim for a refund was precluded by the three-year limitation period. The circuit court, after reciting the facts, affirmed the summary judgment in favor of the United States and adopted the district court's analysis in full.

80. Changes in State Death Taxes in 2014

Maryland, New York, and Rhode Island change their state death taxes and Minnesota repeals its state gift tax

Several changes have occurred with respect to state death taxes since January 1, 2014. New York will gradually increase its exemption to match the federal exemption by January 1, 2019. Taxable gifts within three years of death will be added back to a decedent's estate for purposes of calculation of the New York tax. Maryland also enacted legislation to increase its exemption to the federal exemption amount by January 1, 2019. Rhode Island passed a budget that increased its exemption to $1.5 million indexed for inflation in 2015 and thereafter. Minnesota retroactively repealed the gift tax that it enacted in 2013. The District of Columbia has also passed legislation that may result in the increase of its threshold if certain revenue targets are met.

81. 2015 State Death Tax Chart

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
Alabama	None	Tax is tied to federal state death tax credit. AL ST § 40-15-2.		
Alaska	None	Tax is tied to federal state death tax credit. AK ST § 43.31.011.		
Arizona	None	Tax was tied to federal state death tax credit. AZ ST §§ 42-4051; 42-4001(2), (12). On May 8, 2006, Governor Napolitano signed SB 1170 which permanently repealed Arizona's state estate tax.		
Arkansas	None	Tax is tied to federal state death tax credit. AR ST § 26-59-103; 26-59-106; 26-59-109, as amended March, 2003.		
California	None	Tax is tied to federal state death tax credit. CA REV & TAX §§ 13302; 13411.		
Colorado	None	Tax is tied to federal state death tax credit. CO ST		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		§§ 39-23.5-103; 39-23.5-102.		
Connecticut	Separate Estate Tax	As part of the two year budget which became law on September 8, 2009, the exemption for the separate estate and gift taxes was increased to $3.5 million, effective January 1, 2010, the tax rates were reduced to a spread of 7.2% to 12%, and effective for decedents dying on or after January 1, 2010, the Connecticut tax is due six months after the date of death. CT ST § 12-391. In May 2011, the threshold was lowered to $2 million retroactive to January 1, 2011.		$2,000,000
Delaware	Pick up Only	For decedents dying after June 30, 2009. The federal deduction for state death taxes is not taken into account in calculating the state tax. DE ST TI 30 §§ 1502(c)(2).	On March 28, 2013, the Governor signed HB 51 to eliminate the four year sunset provision that originally applied to the tax as enacted in June 2009.	$5,430,000 (indexed for inflation)
District of Columbia	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001. In 2003, tax imposed only on estates exceeding EGTRRA applicable exclusion amount.	On June 24, 2014, the D.C. Council approved changes to the D.C. Estate Tax. The changes	$1,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		Thereafter, tax imposed on estates exceeding $1 million. DC CODE §§ 47-3702; 47-3701; approved by Mayor on June 20, 2003; effective retroactively to death occurring on and after January 1, 2003. No separate state QTIP election.	include possible increases in the D.C. estate tax threshold to $2 million in 2016 and to the federal threshold of $5 million indexed for inflation in 2018 or later. Both increases are subject to the District meeting or exceeding certain revenue targets which may or may not happen.	
Florida	None	Tax is tied to federal state death tax credit. FL ST § 198.02; FL CONST. Art. VII, Sec. 5		
Georgia	None	Tax is tied to federal state death tax credit. GA ST § 48-12-2.		
Hawaii	Modified Pick-up Tax	Tax was tied to federal state death tax credit. HI ST §§ 236D-3; 236D-2; 236D-B The Hawaii Legislature on April 30, 2010 overrode the Governor's veto of HB 2866 to impose a Hawaii estate tax on residents and also on the Hawaii assets of a non-resident or a non US citizen.	On May 2, 2012, the Hawaii legislature passed HB2328 which conforms the Hawaii estate tax exemption to the federal estate tax exemption for decedents dying after	$5,430,000 (indexed for inflation for deaths occurring after January 25, 2012)

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			January 25, 2012.	
Idaho	None	Tax is tied to federal state death tax credit. ID ST §§ 14-403; 14-402; 63-3004 (as amended Mar. 2002).		
Illinois	Modified Pick-up Only	On January 13, 2011, Governor Quinn signed Public Act 096-1496 which increased Illinois' individual and corporate income tax rates. Included in the Act was the reinstatement of Illinois' estate tax as of January 1, 2011 with a $2 million exemption. Senate Bill 397 passed both the Illinois House and Senate as part of the tax package for Sears and CME on December 13, 2011. It increased the exemption to $3.5 million for 2012 and $4 million for 2013 and beyond. Governor Quinn signed the legislation on December 16, 2011. Illinois permits a separate state QTIP election, effective September 8, 2009. 35 ILCS 405/2(b-1).		$4,000,000
Indiana	None	Pick-up tax is tied to federal state death tax credit. IN ST §§ 6-4.1-11-2; 6-4.1-1-4.	On May 11, 2013, Governor Pence signed HB 1001 which repealed	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			Indiana's inheritance tax retroactively to January 1, 2013. This replaced Indiana's prior law enacted in 2012 which phased out Indiana's inheritance tax over nine years beginning in 2013 and ending on December 31, 2021 and increased the inheritance tax exemption amounts retroactive to January 1, 2012.	
Iowa	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. IA ST § 451.2; 451.13. Effective July 1, 2010, Iowa specifically reenacted its pick-up estate tax for decedents dying after December 31, 2010. Iowa Senate File 2380, reenacting IA ST § 451.2. Iowa has a separate inheritance tax on transfers to remote relatives and third parties.		
Kansas	None	For decedents dying on or		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		after January 1, 2007 and through December 31, 2009, Kansas had enacted a separate stand alone estate tax. KS ST § 79-15, 203		
Kentucky	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. KY ST § 140.130. Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.		
Louisiana	None	Pick-up tax is tied to federal state death tax credit. LA R.S. §§ 47:2431; 47:2432; 47:2434.		
Maine	Pick-up Only	For decedents dying after December 31, 2002, pick-up tax was frozen at pre-EGTRRA federal state death tax credit, and imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003). On June 20, 2011, Maine's governor signed Public Law Chapter 380 into law, which will increase the Maine estate		$2,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		tax exemption to $2 million in 2013 and beyond. The rates were also changed, effective January 1, 2013, to 0% for Maine estates up to $2 million, 8% for Maine estates between $2 million and $5 million, 10 % between $ 5 million and $8 million and 12% for the excess over $8 million. For estates of decedents dying after December 31, 2002, Sec. 2058 deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062. Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non resident's estate. M.R.S. Title 36, Sec. 4064.		
Maryland	Pick-up Tax Inheritance Tax	On May 15, 2014, Governor O'Malley signed HB 739 which repealed and reenacted MD TAX GENERAL §§ 7-305, 7-309(a), and 7-309(b) to do the following:		$1,500,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		1. Increases the threshold for the Maryland estate tax to $1.5 million in 2015, $2 million in 2016, $3 million in 2017, and $4 million in 2018. For 2019 and beyond, the Maryland threshold will equal the federal applicable exclusion amount. 2. Continues to limit the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds the Maryland threshold unless the Section 2011 federal state death tax credit is then in effect. 3. Continues to ignore the federal deduction for state death taxes under Sec. 2058 in computing Maryland estate tax, thus		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		eliminating a circular computation. 4. Permits a state QTIP election.		
Massachusetts	Pick-up Only	For decedents dying in 2002, pick-up tax is tied to federal state death tax credit. MA ST 65C §§ 2A. For decedents dying on or after January 1, 2003, pick-up tax is frozen at federal state death tax credit in effect on December 31, 2000. MA ST 65C §§ 2A(a), as amended July 2002. Tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev. Massachusetts Department of Revenue		$1,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state's new estate tax based upon pre-EGTRRA federal state death tax credit.		
Michigan	None	Tax is tied to federal state death tax credit. MI ST §§ 205.232; 205.256		
Minnesota	Pick-up Only	Tax frozen at federal state death tax credit in effect on December 31, 2000, clarifying statute passed May 2002. Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. MN ST §§ 291.005; 291.03; instructions for MS Estate Tax Return; MN Revenue Notice 02-16. Separate state QTIP election permitted.	On March 21, 2014, the Minnesota Governor signed HF 1777 which retroactively repealed Minnesota's gift tax (which was enacted in 2013). With respect to the estate tax, the new law increases the exemption to $1,200,000 for 2014 and thereafter in annual $200,000 increments until it reaches $2,000,000 in 2018. It also modifies the computation of	$1,400,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			the estate tax so that the first dollars are taxed at a 9% rate which increases to 16%. The new law permits a separate state QTIP election. The provision enacted in 2013 to impose an estate tax on non-residents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota has been amended to exclude certain publicly traded entities. It still applies to entities taxed as partnerships or S Corporations that own closely held businesses, farms, and cabins.	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
Mississippi	None	Tax is tied to federal state death tax credit. MS ST § 27-9-5.		
Missouri	None	Tax is tied to federal state death tax credit. MO ST §§ 145.011; 145.091.		
Montana	None	Tax is tied to federal state death tax credit. MT ST § 72-16-904; 72-16-905.		
Nebraska	County Inheritance Tax	Nebraska through 2006 imposed a pick-up tax at the state level. Counties impose and collect a separate inheritance tax. NEB REV ST § 77-2101.01(1).		
Nevada	None	Tax is tied to federal state death tax credit. NV ST Title 32 §§ 375A.025; 375A.100.		
New Hampshire	None	Tax is tied to federal state death tax credit. NH ST §§ 87:1; 87:7.		
New Jersey	Pick-up Tax Inheritance Tax	For decedents dying after December 31, 2002, pick-up tax frozen at federal state death tax credit in effect on December 31, 2001. NJ ST § 54:38-1 Pick-up tax imposed on estates exceeding federal applicable exclusion amount in effect December 31, 2001 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is		$675,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		below the lowest EGTRRA applicable exclusion amount. The executor has the option of paying the above pick-up tax or a similar tax prescribed by the NJ Dir. Of Div. of Taxn. NJ ST § 54:38-1; approved on July 1, 2002. In Oberhand v. Director, Div. of Tax, 193 N.J. 558 (2008), the retroactive application of New Jersey's decoupled estate tax to the estate of a decedent dying prior to the enactment of the tax was declared "manifestly unjust", where the will included marital formula provisions. In Estate of Stevenson v. Director, 008300-07 (N.J.Tax 2-19-2008) the NJ Tax Court held that in calculating the New Jersey estate tax where a marital disposition was burdened with estate tax, creating an interrelated computation, the marital deduction must be reduced not only by the actual NJ estate tax, but also by the hypothetical federal estate tax that would have been payable if the decedent had died		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		in 2001. New Jersey allows a separate state QTIP election when a federal estate tax return is not filed and is not required to be filed. The New Jersey Administrative Code also requires that if the federal and state QTIP election is made, they must be consistent. NJAC 18:26-3A.8(d)		
New Mexico	None	Tax is tied to federal state death tax credit. NM ST §§ 7-7-2; 7-7-3.		
New York	Pick-up Only	Tax frozen at federal state death tax credit in effect on July 22, 1998. NY TAX § 951. Governor signed S. 6060 in 2004 which applies New York Estate Tax on a *pro rata* basis to non-resident decedents with property subject to New York Estate Tax. On March 16, 2010, the New York Office of Tax Policy Analysis, Taxpayer Guidance Division issued a notice permitting a separate state QTIP election when no federal estate tax return is required to be filed such	The Executive Budget of 2014-2015 which was signed by Governor Cuomo on March 31, 2014 made substantial changes to New York's estate tax. The New York estate tax exemption which was $1,000,000 through March 31, 2014 has been increased	$2,062,500 (as of April 1, 2014 and through March 31, 2015) $3,125,000 (April 1, 2015 through March 31, 2016)

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		as in 2010 when there is no estate tax or when the value of the gross estate is too low to require the filing of a federal return. See TSB-M-10(1)M. Advisory Opinion (TSB-A-08(1)M (October 24, 2008) provides that an interest in an S Corporation owned by a non-resident and containing a condominium in New York is an intangible asset as long as the S Corporation has a real business purpose. If the S Corporation has no business purpose, it appears that New York would look through the S Corporation and subject the condominium to New York estate tax in the estate of the non-resident. There would likely be no business purpose if the sole reason for forming the S Corporation was to own assets.	as follows: April 1, 2014 to March 31, 2015 -- $2,062,500 April 1, 2015 to March 31, 2016 -- $3,125,000 April 1, 2016 to March 31, 2017 -- $4,187,500 April 1, 2017 to December 31, 2018 -- $5,250,000 As of January 1, 2019, the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount. The maximum rate of tax will continue to be 16%. Taxable gifts within three years of death	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			between April 1, 2014 and December 31, 2018 will be added back to a decedent's estate for purposes of calculating the New York tax. The New York estate tax will be a cliff tax. If the value of the estate is more than 105% of the then current exemption, the exemption will not be available.	
North Carolina	None		On July 23, 2013, the Governor signed HB 998 which repealed the North Carolina estate tax retroactively to January 1, 2013.	
North Dakota	None	Tax is tied to federal state death tax credit. ND ST § 57-37.1-04		
Ohio	None	Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax prospectively and		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		granting credit for it retroactively. This was effective June 30, 2005 and killed the sponge tax. On June 30, 2011, Governor Kasich signed HB 153, the biannual budget bill, which contained a repeal of the Ohio state estate tax effective January 1, 2013.		
Oklahoma	None	Tax is tied to federal state death tax credit. OK ST Title 68 § 804 The separate estate tax was phased out as of January 1, 2010.		
Oregon	Separate Estate Tax	On June 28, 2011, Oregon's governor signed HB 2541 which replaces Oregon's pick-up tax with a stand-alone estate tax effective January 1, 2012. The new tax has a $1 million threshold with rates increasing from ten percent to sixteen percent between $1 million and $9.5 million. Determination of the estate for Oregon estate tax purposes is based upon the federal taxable estate with adjustments.		$1,000,000
Pennsylvania	Inheritance Tax	Tax is tied to the federal state death tax credit to the extent that the available federal state		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		death tax credit exceeds the state inheritance tax. PA ST T. 72 P.S. § 9117 amended December 23, 2003. Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax which is independent of the federal state death tax credit. Pennsylvania recognizes a state QTIP election.		
Rhode Island	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001, with certain adjustments (see below). RI ST § 44-22-1.1. Rhode Island recognized a separate state QTIP election in the State's Tax Division Ruling Request No. 2003-03. Rhode Island's Governor signed into law HB 5983 on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments	On June 19, 2014, the Rhode Island Governor approved changes to the Rhode Island Estate Tax by increasing the exemption to $1,500,000 indexed for inflation in 2015 and eliminating the cliff tax.	$1,500,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U). . . rounded up to the nearest five dollar ($5.00) increment." RI ST § 44-22-1.1.		
South Carolina	None	Tax is tied to federal state death tax credit. SC ST §§ 12-16-510; 12-16-20 and 12-6-40, amended in 2002.		
South Dakota	None	Tax is tied to federal state death tax credit. SD ST §§ 10-40A-3; 10-40A-1 (as amended Feb. 2002).		
Tennessee	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. TN ST §§ 67-8-202; 67-8-203. Tennessee has not decoupled, but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.	On May 2, 2012, the Tennessee legislature passed HB 3760/SB 3762 which phases out the Tennessee Inheritance Tax as of January 1, 2016. The Tennessee Inheritance Tax Exemption is increased to $1.25 million in 2013, $2 million in 2014, and $5	$5.000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			million in 2015. On May 2, 2012, the Tennessee legislature also passed HB 2840/SB2777 which repealed the Tennessee state gift tax retroactive to January 1, 2012.	
Texas	None	Tax is tied to federal state death tax credit. TX TAX §§ 211.001; 211.003; 211.051		
Utah	None	Tax is tied to federal state death tax credit. UT ST § 59-11-102; 59-11-103.		
Vermont	Modified Pick-up	In 2010, Vermont increased the estate tax exemption threshold from $2,000,000 to $2,750,000 for decedents dying January 1, 2011. As of January 1, 2012 the exclusion is scheduled to equal the federal estate tax applicable exclusion, so long as the FET exclusion is not less than $2,000,000 and not more than $3,500,000. VT ST T. 32 § 7442a. Previously the estate tax was frozen at federal state death tax credit in effect		$2,750,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		on January 1, 2001. VT ST T. 32 §§ 7402(8), 7442a, 7475, amended on June 21, 2002. No separate state QTIP election permitted.		
Virginia	None	Tax is tied to federal state death tax credit. VA ST §§ 58.1-901; 58.1-902. The Virginia tax was temporarily repealed effective July 1, 2007. Previously, the tax was frozen at federal state death tax credit in effect on January 1, 1978. Tax was imposed only on estates exceeding EGTRRA federal applicable exclusion amount. VA ST §§ 58.1-901; 58.1-902.		
Washington	Separate Estate Tax	On February 3, 2005, the Washington State Supreme Court unanimously held that Washington's state death tax was unconstitutional. The tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002 - 2004 and eliminating it for the years 2005 - 2010. Hemphill v. State Department of Revenue 2005 WL 240940 (Wash. 2005).	On June 14, 2013, Governor Inslee signed HB 2075 which closed an exemption for marital trusts retroactively immediately prior to when the Department of Revenue was about to start issuing refund checks, created a	$2,054,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		In response to Hemphill, the Washington State Senate on April 19 and the Washington House on April 22, 2005, by narrow majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A election could have been taken (regardless of whether the election is made). The Governor signed the legislation. WA ST §§ 83.100.040; 83.100.020. Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections. Washington permits a separate state QTIP election. WA ST §83.100.047.	deduction for up to $2.5 million for certain family owned businesses and indexes the $2 million Washington state death tax threshold for inflation.	
West Virginia	None	Tax is tied to federal state death tax credit. WV § 11-11-3.		
Wisconsin	None	Tax is tied to federal state death tax credit. WI ST § 72.01(11m). For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. Thereafter, tax imposed only on estates exceeding EGTRRA federal applicable exclusion amount. WI ST §§ 72.01; 72.02, amended in 2001; WI Dept. of Revenue website. On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provided that Wisconsin will not impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident's state of domicile does not impose a death tax. Previously, Wisconsin would impose an estate tax with respect to the intangible personal property of a non-resident		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax.		
Wyoming	None	Tax is tied to federal state death tax credit. WY ST §§ 39-19-103; 39-19-104.		

BIFURCATING TRUSTEE DUTIES – DRAFTING, TAX AND ADMINISTRATIVE CONSIDERATIONS

Materials prepared by Dan Schrauth, Managing Director, J.P. Morgan Private Bank, San Francisco & Palo Alto for the 37th Annual UCLA/CEB Estate Planning Institute

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Fiduciary Liability – General Considerations When Carving Up Trustee Responsibilities

- Starting point: trustee (or co-trustees jointly) owe fiduciary duties and are liable to beneficiaries for all trust investment decisions, distributions decisions and administration

- However, many clients wish to divide responsibilities among different parties
  - Step #1: Determine client's optimal allocation of responsibilities
  - Step #2: Determine optimal legal structure of trust to clearly define the responsibilities and liabilities of each party involved in the trust

- Structural options to carve up trustee responsibilities:
  - Delegation (less certainty regarding who is responsible and liable for what)
  - Direction (more certainty regarding who is responsible and liable for what)
  - And those grey areas that don't technically fall under a delegation or direction, e.g., the trustee is encouraged, but not required, to seek the advice of a named individual or committee concerning some or all investment/distribution decisions

Fiduciary Liability – Delegation Basics

- Traditionally, a trustee had a duty not to delegate trustee responsibilities

- However, tradition has yielded given the complexities of modern investment management
  - UPIA permits a trustee to delegate investment management
  - UPIA also provides that a delegating trustee is not liable if the delegating trustee exercises reasonable care, skill and caution in (i) selecting agent, (ii) establishing scope of delegation and (iii) monitoring agent (e.g., see California Probate Code §16052(c))

- Delegation typically arises with respect to trust investment decisions (over some or all trust assets) although a delegation from one co-trustee to another co-trustee may also arise with respect to distribution decisions and administrative tasks

- If an individual is serving as sole trustee, the individual trustee hiring an investment advisor (i.e., an "agent") to manage the trust assets is typically viewed as a "delegation"

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- If a corporate trustee is serving as sole trustee, the corporate trustee probably will not be comfortable delegating investment management of trust assets to an independent advisor selected by the grantor or beneficiary if the corporate trustee has the requisite in-house expertise and skill to manage the trust assets in question

- If an individual and a corporate trustee are serving as co-trustees, it is not uncommon for the individual co-trustee to delegate investment management responsibility to the corporate trustee; however, the inverse is not as common for the reason described above

- Remember - delegation doesn't absolve delegating trustee of the duty to monitor and be actively involved

Fiduciary Liability – Direction Basics

- Typically arises in connection with trust investment decisions (over all or specially identified trust assets) and/or trust distribution decisions

- The hallmarks of a true direction scenario:
    - The party providing direction has fiduciary responsibility for decisions and outcomes
    - The party carrying out the direction (i.e., the "directed trustee" that is often a corporate trustee but could be an individual trustee) has no fiduciary responsibility for decisions and outcomes, and no duty to monitor/approve the actions, inactions and decisions of the party providing direction

- Consider directed trust approach when grantor, trustees and beneficiaries want a greater degree of control and certainty regarding "who is in charge" and who is liable for what

- Directed trust for some or all investment decisions is particularly relevant if trust holds illiquid assets (e.g., family business interests), concentrations or "emotional tie" assets

- Direction scenario achieved by trust instrument providing that a "trust advisor", "investment committee", "special investment trustee", etc., has the power and responsibility to direct trust investments (could be all trust assets or just specially identified trust assets) whereas the "regular" trustee has power and responsibility for

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trust distributions and administration; same approach can be employed for distribution decisions

- If an individual co-trustee is serving with a corporate co-trustee, the individual co-trustee could be vested with the power to direct the corporate trustee on some or all investment and/or distribution decisions

Fiduciary Liability – Not all Direction Scenarios Are Created Equal

- Does directed trustee have a duty to monitor/supervise/approve of a trust advisor's actions/inactions/decisions?
    - If so, this is not ideal – directed trustee should not be required to monitor
    - What does trust instrument say?
    - What does state law provide, i.e., is there a directed trust statute and what does it say?

- Highest degree of certainty is to act under administrative law of a state with a protective directed trust statute, e.g., Delaware
    - DE statute says directed trustee not liable for following direction of trust advisor except in cases of willful misconduct (no duty to monitor/inquire)
    - Willful misconduct is defined as "intentional wrong doing, not mere negligence, gross negligence, or recklessness" (12 Del. C. §§ 3301(a) and 3301(h)(4)) – the 2011 revision to the statute defines "wrong doing" as intentionally malicious conduct or conduct intended to defraud or seek an unconscionable advantage
    - Only case on record involving DE directed trust statute upholds the statute - *Duemler v. Wilmington Trust Company* , 20033 NC, 2004, Strine, V.C. (Nov. 24, 2004)

- Some states have a less protective directed trust statute that is modeled on the UTC approach
    - UTC §808 – trustee shall act in accordance with direction "unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of the fiduciary duty" of the person holding the power
    - In other words, the UTC puts an obligation on the directed trustee to review/monitor

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- Restatement 2d §185 likewise puts upon directed trustee the duty to ascertain whether the exercise violates the terms of the trust or is a violation of fiduciary duty (basically treats directed trustee like co-trustee)

- Restatement 3d §74 language is very similar, i.e., contrary to the terms of the trust or knows or has reason to believe exercise violates fiduciary duty of holder

- CA does not have a directed trust statute; however, that does not prohibit practitioners from drafting a direction scenario (with appropriate direction language) into a CA irrevocable trust. Notwithstanding the foregoing, a corporate trustee with offices in a state with a protective directed trust statute (e.g., DE) may be reluctant to serve as trustee of a directed CA trust and will probably prefer to administer the trust out of a state like DE

How to Create a Directed Trust

- Direction language and creation of trust advisor/directing co-trustee role must be in the trust instrument
  - Can't create direction scenario by separate agreement, e.g., co-trustees can't agree/contract that one co-trustee won't have any responsibility/liability over certain trust investments or distribution decisions (that would be delegation not direction)

- Terminology used in the trust instrument can vary, e.g., investment/distribution trustee, special trustee, investment/distribution committee, trust advisor, investment/distribution advisor, etc., but regardless of terminology used, the instrument should be very clear about who is vested with power to "direct" over what trust investments - all or just specific trust assets – and/or what trust distribution decisions

The Case for Always Drafting Direction Language into Long-Term GST Trusts?

- When drafting new trusts (especially long-term GST trusts), should it be a best practice for drafting attorney to always include investment/distribution direction language and a trust advisor or investment/distribution trustee role even if the role won't be occupied immediately?
  - For example, give trust protector the power to appoint trust advisor in the future even if the role will be initially vacant?

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- Or say that if the individual trustee initially appointed (or any successor individual trustee) is ever serving together with a corporate co-trustee, the individual co-trustee can direct the corporate co-trustee on some/all investment and/or distribution decisions?

- Remember that a trust agreement containing direction language does not need to be initially created in a state with a direction statute
  - Even though CA does not have a directed trust statute, CA law does not prohibit directed trusts
  - Investment and/or distribution direction is a matter of trust "administration", which can change depending on the situs of administration vs. trust "validity" or "construction", which generally stays with the original situs of the trust
  - For example, assume client creates a CA irrevocable trust, names an individual trustee, but the trust contains direction language in case a corporate trustee or more risk-minded individual trustee is appointed in the future. If a corporate trustee is later appointed and such corporate trustee has offices in a state with a directed trust statute, the corporate trustee may be able to administer the trust out of its office in the directed trust jurisdiction and gain protection from the directed trust statute notwithstanding that the trust was originally created in CA

Adding Direction Language to an Existing Irrevocable Trust

- If dealing with an older trust without direction language, consider modifying trust instrument by reformation (or possibly decanting if available) to add appropriate direction language

- Modify/reform the trust per a judicial proceeding (or non-judicial proceeding if state law permits) to add direction language
  - Court reformations in the DE Court of Chancery to add investment direction language are common and can be accomplished in a matter of weeks dependent on the complexity of the situation; DE virtual representation statute applies for minors and unborns

- Dependent on state law and the governing instrument, it may be possible to appoint a trustee or co-trustee in a state with a decanting statute who can then decant the trust to add investment direction language (could also theoretically be done in a state

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without a decanting statute if the trust contains express decanting language and if the trustee is willing to exercise decanting discretion)

- Reforming vs. decanting to add direction language:
  - Legal costs are often about the same
  - Beneficiaries generally involved in either, although beneficiary knowledge/consent not technically required for a decanting
  - Judicial reformation , e.g., in DE Chancery Court, is public vs. decanting which is private
  - Also, need to determine whether any potential tax issues with decanting, e.g., will a complete decanting trigger a need to re-title existing trust assets and/or get a new taxpayer ID number (may be a reason why reformation is more efficient in certain situations)

<u>State Fiduciary Income Tax Considerations When Carving Up Trustee Responsibilities</u>

- Taxability of accumulated, non-CA source trust income and gain depends on residence of "fiduciaries" and/or beneficiaries whose interests in the trust are "non-contingent" (CA Rev. & Tax. Code Section 17742(a))

- Who is a "fiduciary" under CA R&T§17742(a)?
  - R&T§17006 defines fiduciary to mean guardian, trustee, executor, administrator, receiver, conservator or "any person . . . acting in any fiduciary capacity for any person, estate or trust"

- If a trustee delegates certain trustee responsibilities to a non-trustee trust participant, such delegatee/agent should arguably not be considered a "fiduciary" for CA income tax purposes

- If a CA co-trustee delegates all trustee responsibilities to a non-CA co-trustee, will the CA "passive" co-trustee still be considered a "fiduciary" for CA income tax purposes?

- In a directed trust situation, if a CA resident individual is "directing" the trustee on some or all investment and/or distribution decisions, is such individual a "fiduciary" for CA income tax purposes?
  - No authority on this issue although CA would probably say "yes"
  - The DE and SD directed trust statutes define a "trust advisor" (i.e., individual directing the trustee) as a "fiduciary"; however, these statutes provide that it is

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possible (per the terms of the trust instrument) to opt-out of fiduciary status. Is this a practical solution or not to protect against CA tax?

  - The AK directed trust statute provides a presumption against "fiduciary" status for a trust advisor
  - Would the CA FTB give any weight to whether a non-CA directed trust statute and/or the governing instrument define a trust advisor as a fiduciary or not? Maybe, but CA would probably argue substance over form even if trust advisor defined as a "non-fiduciary" role
  - Would CA consider an individual holding a veto power over investment or distribution decisions a "fiduciary"?

- What if the trust structure is not a delegation or a direction but something in between, e.g., an individual who "advises" the trustee and the trustee is encouraged, but not required, to follow such individual's advice?
  - Arguably not a "fiduciary" for CA purposes since the trustee is not obligated or directed to follow the "advice"

- Individual with the power to remove and replace trustees (or trust advisors in the case of a directed trust) is arguably not a "fiduciary" for CA income tax purposes

- Example of moving trust situs to avoid CA tax based on CA resident fiduciary
  - Assume trust holds highly appreciated position, which trustee/beneficiaries would like to sell (or position may be involuntarily liquidated due to sale of company) and avoid paying CA tax on gain
  - If CA resident trustee resigns in favor of a non-CA trustee before position is sold, gain should not be reportable to CA (assuming no CA resident "non-contingent" beneficiaries)
  - "Close the book" accounting method should apply if trust ceases to be a CA taxpayer on date CA trustee resigns (see 541 instructions and Pub. 1100). Example: CA trustee resigns on 4/30/15 in favor of a non-CA trustee; CA return required only for period 1/1/15 – 4/30/15. If sale of appreciated trust assets occurs on 5/1/15, gain attributable to such sale should not be reportable to CA

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SAMPLE LANGUAGE FOR DELAWARE DIRECTED TRUST WHERE INDIVIDUAL "TRUST ADVISOR" DIRECTS CORPORATE TRUSTEE ON ALL INVESTMENTS

Note: Sample language below can be modified so Trust Advisor only directs trustee on "Special Assets" either named/identified in the trust agreement or identified by the Trust Advisor. Sample language below can also be modified if an individual co-trustee (vs. a Trust Advisor) will have the power to direct the corporate co-trustee on some or all investment decisions.

This is sample language only and should not be construed as providing legal advice.

Powers and Duties of Trust Advisor. The Trust Advisor shall direct the Trustee with respect to any and all investment decisions related to the trust estate of any trust created under this instrument. Such investment decision actions and inactions shall include, without limitation, purchases, retentions, sales, exchanges, loans, pledges and other dispositions. As provided in Section 3313 of Title 12 of the Delaware Code, in no event shall any Trustee hereunder be liable for any matter with respect to which he, she or it is directed pursuant to this provision except in cases of such Trustee's own willful misconduct. The Trustee shall have no authority with respect to any such investment decision actions or inactions with respect to any asset of the trust estate, except as may be necessary from time to time to carry out the directions of the Trust Advisor.

No Trustee Duties. The Trustee shall not participate in or have any liability for the selection of the Trust Advisor. The Trustee shall not have any duty to seek any direction from the Trust Advisor. While a Trust Advisor is serving, the Trustee shall have no responsibility to monitor the performance of the Trust Advisor or the performance of any trust assets, or to consider the advisability of purchasing, retaining, selling, exchanging, loaning, pledging or disposing of any trust assets.

Initial Trust Advisor. The initial Trust Advisor of any and all trusts under this instrument shall be [_____(Name)_____]. **[If no current Trust Advisor will be serving, include provisions whereby Trust Protector or other trust participant has the power to appoint a Trust Advisor in the future]**

Appointment, Removal, Resignation and Replacement of Trust Advisors. **[Incorporate with other removal/replacement provisions in the trust agreement]**

Trust Advisor Compensation. The Trust Advisor shall be entitled to reimbursement for such out-of-pocket expenses from the trust estate as are necessary and reasonable for the

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performance of the Trust Advisor's duties hereunder. **[Also include provision re Trust Advisor compensation if relevant]**

Directions to Trustee. Any investment direction from the Trust Advisor to the Trustee shall be in writing, delivered by mail, courier, facsimile transmission, electronic mail, or otherwise in such form as the Trustee may specify from time to time by written notice to the Trust Advisor. The Trustee shall have no obligation to investigate or confirm the authenticity of directions it receives or the authority of the person or persons conveying them, and the Trustee shall be exonerated from any and all liability in relying on any such direction from a person purporting to be the Trust Advisor without further inquiry by the Trustee.

Duty to Confirm Value of Assets and Other Duties. In addition to the Trust Advisor's duties herein, the Trust Advisor shall have the duty (a) to confirm to the Trustee, in writing, the value of trust assets for which no readily available market quotation exists, at least annually and upon request by the Trustee, (b) to manage or participate in the management of any entity owned by the trust, to the extent such entity's governing instruments or applicable law require the owners to manage the same, (c) to direct the Trustee with respect to making any representation, warranty or covenant required to be made in order to maintain any investment, and (d) to direct and instruct the Trustee on the future actions, if any, to be taken with respect to such representations, warrantees and covenants. **[Include provisions about voting trust assets if applicable – but be aware of potential 2036(b) issues especially if the grantor is serving as the Trust Advisor]**

Trust Advisor's Power to Hire the Corporate Trustee as Investment Advisor. The Trust Advisor may hire the Trustee as an investment advisor with respect to some or all of the trust assets. To the extent that the Trust Advisor engages the Trustee or an affiliate of the Trustee to manage trust assets, the Trustee or such affiliate may invest without regard to any generally-applicable restriction on self-dealing or violation of any rule against divided loyalty or other conflict of interest. In exercising this power, the Trustee may engage in transactions with itself, its affiliates and entities for which the Trustee or any affiliate acts as an investment advisor or manager or performs custody or other services, in which case the Trustee, affiliate or entity may be compensated for those services without reducing the compensation that the Trustee is entitled to receive for its services as a fiduciary.

When There Is No Trust Advisor Acting. At any time there is no Trust Advisor acting, provided the Trustee shall have received actual written notice of the Trust Advisor's resignation, or of the Trust Advisor's removal by the removing party, or of the Trust Advisor's incompetency from the Trust Advisor's attending physician or of the Trust Advisor's death by delivery to the Trustee of a copy of the Trust Advisor's death

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certificate, the Trustee shall have all authority of the Trust Advisor until (and unless) the persons holding the authority to appoint a successor Trust Advisor have effectively appointed a successor Trust Advisor. At any time or times when the Trustee is exercising the powers theretofore exercised upon the direction of the Trust Advisor, the Trustee shall be under no duty to examine the actions of any Trust Advisor that served theretofore or to inquire into the acts or omissions of any such Trust Advisor and shall not be liable for any act or omission of any such Trust Advisor and shall not be liable for any failure to seek redress for any act or omission of any such Trust Advisor. At any time or times when the Trustee is exercising the powers theretofore exercised upon the direction of the Trust Advisor, the Trustee may sell, transfer, exchange, convert or otherwise dispose of, any property held as part of the trust fund, at public or private sale, with or without security, and without regard to tax implications, in such manner, at such time or times, for such purposes, for such prices and upon such terms, credits and conditions as the Trustee, in its sole and absolute discretion, may deem advisable. The Trustee may also retain any such property for any period, whether or not the same be speculative or be of the character or proportion permissible for investments by fiduciaries under any applicable law, without regard to any effect the retention may have upon the diversification of the investments, and without regard to liquidity of, or any change in the value of any particular investment. The Trustee shall be under no duty to sell or otherwise dispose of any particular investment merely because of the amount or value of such investment or type of investment in relation to the total amount or value of the trust fund.

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Bifurcating Trustee Duties: Drafting, Tax and Administrative Considerations

Select Topics by Linda J. Retz of the Law Offices of Linda J. Retz, Torrance, California

Some clients prefer to spread the responsibility for a Trust's administration among two or more individuals or institutions whom they perceive as having different attributes to commend them. In addition, there are certain powers which, if held by a beneficiary or grantor serving as Trustee, can have negative tax implications; and there are certain types of assets for which a particular Trustee may not wish to be responsible. Persons other than the Trustees who are charged with certain aspects of a Trust's administration may be referred to as Special Trustees, Independent Trustees, Trust Advisors or Trust Protectors (to name a few terms).

A. Examples of Bifurcated Duties and Responsibilities. The following is a representative (but not exhaustive) list of duties and responsibilities clients may wish to vest in someone other than the Trustee (or in some but not all Co-Trustees).

1. Core Responsibilities

a. Investment Decisions: When a corporate fiduciary serves as sole Trustee or as Co-Trustee with an individual, clients frequently choose to have the corporate Trustee make investment decisions. But what if there are some assets for which a Trustee does not wish to be responsible? For example, a corporate Trustee may have a policy of not taking title to contaminated real property and may not want to be involved in the operation of a closely-held business. By the same token, if a client owns assets with others, the client may prefer that a beneficiary having a pre-established relationship with the co-owners make important decisions about their joint investment.

b. Distribution Decisions.

(i) When a corporation or individual who does not have a close relationship with the beneficiaries is named to serve as Trustee, someone having a closer relationship with the beneficiaries can be named to make decisions about distributions for them.

(ii) In some cases, a more detached relationship between a beneficiary and Trustee may be appropriate. Take a situation where a beneficiary has a substance abuse problem and the clients are considering naming one of the beneficiary's siblings as Trustee. The beneficiary

may have no qualms about taking whatever measures are necessary to coerce the sibling to make distributions the beneficiary desires (including calling the sibling frequently at his or her place of employment). These tactics are likely to fall flat with a corporate fiduciary. In these circumstances, why not vest a corporate Trustee alone with the power to make discretionary distributions? But query whether a corporate Trustee would "sign on" if its only responsibility is to make distribution decisions.

(iii) If distributions are directed to be made to a child at a certain age, the child serves as Trustee and as that age approaches the child has a substance abuse problem, is in the midst of a divorce or has another serious problem, it is helpful if someone other than the child has the power to postpone the distribution that is about to take place (until the storm passes).

(iv) By the same token, some clients (perhaps a minority) will allow a third party to make distributions to children or grandchildren at earlier ages than those specified in the Trust document if a beneficiary exhibits exceptional maturity.

c. Administrative Responsibilities. Simply put, some fiduciaries have greater business acumen than others. If a corporate fiduciary is not named, it may make sense to vest the responsibility for filing tax returns, making certain tax elections and exercising powers related to tax savings in the family accountant or someone else who is knowledgeable in tax matters.

2. Situational Responsibilities

a. If a beneficiary serves as Trustee and the Trustee may make principal distributions benefitting himself or herself which do not fit within an "ascertainable standard," adverse estate tax consequences ensue (under Internal Revenue Code section 2041). Adverse estate tax consequences also ensue if a Trustee has the power to make distributions that discharge the Trustee's legal obligation to support the beneficiary or if a life insurance policy is owned on a beneficiary's life and, as Trustee, the beneficiary possesses incidents of ownership with respect to the policy, e.g., the power to change the beneficiary or to borrow against the policy. (See Treas. Reg. section 20.2041-1(c)(1)(c) and Internal Revenue Code section 2042, respectively.)

b. If a grantor serves as Trustee of an irrevocable Trust, the following powers should be vested in someone other than the grantor/trustee: To vote the stock of a closely-held corporation, to reimburse the grantor for the payment of taxes on the income of a grantor retained annuity trust; to lease a residence owned by a qualified personal residence trust ("QPRT") back to the grantor after the end of the QPRT term; to convert a grantor trust to a non-grantor trust; to make principal distributions for a beneficiary for purposes that fall outside of an ascertainable standard; and to value assets of a charitable remainder unitrust each year (in order to determine the amount to which the grantor is entitled during the Trust term). (See Internal Revenue Code sections 2036 and 2038.)

c. Sometimes the best tax plan is a flexible tax plan. It may be wise to allow someone other than a beneficiary to amend a Trust within certain parameters. For example, if a trust owns or acquires subchapter S stock, someone other than the beneficiary can be given the power to convert an otherwise non-qualifying trust into a qualified subchapter S trust or an electing small business trust. In so qualifying a trust, that individual may have to limit the number of current beneficiaries or direct that all net income from the trust be distributed to a single individual. By the same token, someone who is not a Trust beneficiary can be given the power to grant powers to the beneficiaries that will result in tax savings. (This can be done to save generation-skipping transfer taxes or to obtain a second step-up in basis for appreciated assets on a surviving spouse's death.)

d. Clients may want to consider appointing someone who participates actively in the management of a business as the Trustee of that business to save the 3.8% tax on net investment income.

e. Third parties may be needed to keep peace between the Trustee and beneficiaries. If beneficiaries cannot agree on the division of valuable art, classic automobiles or other tangible personal property and interested persons are serving as Trustees, an arbiter comes in handy. If two Co-Trustees find themselves at a stalemate, it is helpful to name an independent party to resolve the deadlock or difference of opinion. In a blended family situation with family members serving as Trustees, it can be helpful to name someone outside of the family to make important tax elections (like the portability and QTIP elections).

f. If a Trustee lacks expertise in a certain key area, the beneficiaries may benefit from having someone else step in to make decisions in that area.

For example, an author or songwriter may own valuable copyrights. Intellectual property is a world unto itself and the client's business manager or other Trustee may lack the expertise to spot issues with respect to such things as termination rights (in whom they are vested or when they arise).

g. In California the Trustee of shares of stock or other interests in a professional practice must be licensed to practice that profession. More often than not, the person who succeeds a physician, lawyer, accountant or architect as Trustee is not a licensee. In these circumstances, another Trustee is needed to hold title to (and exercise powers with respect to) the professional practice.

h. Many clients love their animals and regard them as members of the family. They want to be sure the animals are cared for and placed in good homes after they die. Corporate and some individual Trustees do not want to be vested with the responsibility of seeing to the care of animals. Clients owning valuable horses or other animals may appoint a team (of trainers, veterinarians and caretakers) to see to the well-being of their animals after their deaths.

B. <u>Drafting Tips</u>

1. Careful drafting is essential to protect power holders from liability for the decisions of other power holders. It is especially important in States like California that do not have directed trust statutes. In those States, the relationship between the Trustee and someone having the power to advise or direct the Trustee (on a particular subject) is uncertain. As a result, an agency or Co-Trustee relationship can be implied between the parties, which it is important to negate.

2. In drafting, the first consideration is what powers will be vested in the Special or Independent Trustee or Trust Protector or Advisor? Think carefully about this decision. Among other things, consider whether the individual is qualified to make decisions on the subjects at hand. Do these decisions require an expertise in tax matters or unique assets (such as art or intellectual property)? Do the powers being vested in this individual presuppose a close relationship with the client's family members? How much does the client trust this individual?

3. Signs you may be going overboard in vesting powers in a Special or Independent Trustee or Trust Protector or Advisor include:

    a. Many different kinds of expertise are required to exercise all of the powers vested in him or her prudently and the individual in question may not possess all of those talents.

    b. The powers vested in the individual are so broad that they enable him or her to virtually change the estate plan in ways that may not be intended by the client.

4. Draftspersons differ on whether powers vested in someone other than the Trustee should be held in a fiduciary or non-fiduciary capacity. The manner in which powers are held can have tax implications as well as non-tax implications. Generally speaking, the author is concerned about the recourse beneficiaries will have if they are harmed by the exercise of a power held in a non-fiduciary capacity.

5. Other things to think about in drafting documents include:

    a. The inclusion of language to exculpate fiduciaries from the acts of other fiduciaries and from the acts of persons holding powers in non-fiduciary capacities (if any).

    b. When do the powers in question arise?

    c. Does a Trustee have to share information with other power holders? If so, how much?

6. Some Trusts (particularly some older Trusts) allow a beneficiary or third party to veto a decision made by the Trustee (perhaps an investment the veto power holder considers too risky). Veto powers are generally not welcomed by the Trustee.

7. If a corporate Trustee is named, allow it to review the Trust instrument to make sure that it is comfortable with the division of labor and Trust terms. Generally, speaking, corporate fiduciaries will not serve solely as Trust Protectors or Advisors for California Trusts.

8. Sample Clause to Name Independent Trustee and Distinguish Him or Her from the Trustee:

While no Current Beneficiary or Remainder Beneficiary and no one with a legal obligation to support a Current Beneficiary is serving as Trustee, all powers of the Independent Trustee shall be vested in the Trustee and an Independent Trustee need not be appointed. While a Current or Remainder Beneficiary or someone with a legal obligation to support a Current Beneficiary (an "Interested Party") is serving as Trustee, the Independent Trustee shall be all Co-Trustees who are not Interested Parties. If all Co-Trustees are Interested Parties, the Independent Trustee shall be the first successor Trustee who is not an Interested Party and who is able and willing to serve as Independent Trustee. If there is no such successor Trustee, the Trustee shall have the power to appoint an Independent Trustee who is not an Interested Party or someone who is "related" or "subordinate" (as those terms are defined in Internal Revenue Code Section 672) to an Interested Party. Any such appointment shall be made by written instrument delivered to the appointee and to each Current Beneficiary other than the Trustee.

(a) The term "Trustee," as used in this instrument, shall not be deemed to include an Independent Trustee who is not also serving as Trustee. The Independent Trustee (i) shall serve in a fiduciary capacity, (ii) shall hold only those powers specifically vested in the Independent Trustee by the express provisions of this instrument, and (iii) shall exercise those powers by a written instrument delivered to the Trustee. The Independent Trustee shall have no other powers or responsibility for the administration of Trust assets unless the Independent Trustee is also serving as a Trustee.

(b) The Trustee shall have no duty to inquire into and shall have no liability for the acts of the Independent Trustee; the Independent Trustee shall have no duty to inquire into and shall have no liability for the acts of the Trustee; and neither shall have a duty to see to the performance of the duties of the other. The Trustee shall carry out the decisions of the Independent Trustee with respect to the powers vested in the Independent Trustee.

(c) The Trustee shall provide the Independent Trustee with access to Trust records, and respond to inquiries posed by the Independent Trustee, that are pertinent to the exercise of the Independent Trustee's powers and discretions.

9. Sample Powers Given to Independent Trustees:

(a) After a child attains ____ years of age, the Trustee shall distribute to or apply for the benefit of the child all of the net income of the child's trust, in quarterly or more frequent installments. If the Trustee deems the net income of a child's trust to be insufficient for that child's support, health and education, the Trustee may distribute to or apply for the benefit of the child as much of the principal of the child's trust as the

Trustee, in the Trustee's discretion, deems necessary or appropriate for those purposes. The Independent Trustee may, in the Independent Trustee's discretion, make additional distributions of principal to or for the benefit of a child for the child's comfort and happiness.

(b) The Independent Trustee shall have the power to terminate a trust if that trust has a value of less than Seventy-Five Thousand Dollars ($75,000), or if the Independent Trustee shall determine, in the Independent Trustee's discretion, that the value of the trust has become so low in relation to the cost of administering the trust that its continuance pursuant to its terms will defeat or substantially impair the accomplishment of the purposes of the trust. Upon such termination, the Trustee shall distribute to the Current Beneficiary all of the principal and accumulated income, if any, of the trust. If there is more than one Current Beneficiary, the Trustee shall distribute the principal and accumulated income to them in the shares to which they are entitled to benefits. If no shares are specified, distribution to the Current Beneficiaries shall be made in shares determined by the Independent Trustee, in the Independent Trustee's discretion.

(c) Notwithstanding any other provision of this instrument, no Trustee of any trust created under this instrument who has a legal obligation to support a beneficiary may participate in the exercise of any discretion to make payments, distributions or applications of benefits in discharge of that obligation. The power to exercise any such discretion shall be vested in the Independent Trustee. However, the provisions of this Section 1.3 shall not apply to the Settlor while [he/she] is serving as Trustee.

(d) The Independent Trustee may direct the Trustee to postpone distributions of income or principal of a child's trust (other than income of a qualified subchapter S trust) if the Independent Trustee determines, in the Independent Trustee's discretion, that there is good reason to do so, such as but not limited to, the child's serious disability, pending divorce, potential financial difficulty, substance abuse or apparent inability to manage funds wisely. While any distribution is postponed, the retained portion of the child's trust shall be administered as though the child had not yet reached the age for distribution. If a distribution of income is postponed that is not dependent on a child's age, then during the period of the postponement, that income shall be added to principal of the child's trust and distributions may be made to or for the benefit of the child in keeping with the provisions of Section ____. Any distribution may be postponed temporarily or indefinitely, for example, throughout the child's lifetime.

(e) The Trustee shall have the power to relinquish or restrict the scope of any power vested in the Trustee by a written disclaimer or other written instrument. Any power disclaimed or otherwise relinquished by the Trustee shall be vested in the Independent Trustee (unless also disclaimed or relinquished by the Independent Trustee).

TO TWEET OR NOT TO TWEET? ETHICS RULES AND SOCIAL MEDIA: AN ATTORNEY'S GUIDE TO ETHICALLY NAVIGATING THE SOCIAL MEDIA LANDSCAPE

The 37th Annual CEB/UCLA Estate Planning Institute

May 2015

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Weintraub Tobin

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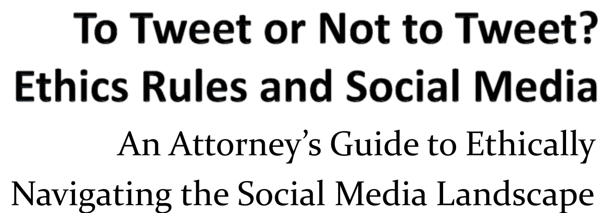

Mary K. deLeo

A Whole New World

- In year 2000, 42% of U.S. homes had Internet access
- By year 2013, 73% of U.S. homes had Internet access
- In year 2011, 35% of Americans had a smartphone
- By year 2014, nearly 70% of Americans had a smartphone
- In 2010, 48% of Americans had a profile on a social networking site
- By 2014, 67% of Americans had a profile on a social networking site
- 72% of all internet users are active on social media
- 18-29% year olds have an 89% usage

Social Media Defined

- What is "Social Media?"
  - Catch-all phrase for community-modeled websites and channels that encourage interaction, feedback and contributions from users
  - Users create a profile about themselves, connect with other users, and share information about themselves
  - Characterized by two-way communication versus one-way "broadcast" communication; solicits participation as opposed to delivering content
  - Promotes connectivity to other sites, resources, and people
  - Tailored advertising and messaging
  - Typically have minimal or inadequate barriers to accessing and using content

Basic Forms of Social Media

- Social Networks: Sites that allow users to build personal webpages and connect to other users' webpages for sharing of content. Examples: Facebook, Linked-In, Instagram, Snapchat, Google+
- Blogs: Personal online journals, which are frequently updated, and are meant for public consumption.
- Microblogging: Website service that allows subscribers to disseminate small amounts of content – sentences, video, or photographs – to other subscribers online or via smartphones. Examples: Twitter, Tumblr

Basic Forms of Social Media

- Content Communities: Online communities that organize and share particular kinds of content, such as photographs or videos. Examples: YouTube, Pinterest,
- Forums: Online discussion sites typically grouped around specific subjects or interests.
- Wikis: Websites that consist of a communal document designed to be edited or added to by users

Top Social Media Sites

- Facebook:
  - 900 million monthly users
  - Users post personal information such as current status, current location, photographs, contact information, and conversations between users
  - Users have the option to have all of their posted information public, to limit public information to only name and profile picture, or to set privacy setting somewhere in the middle
  - Users “friend” other users

Top Social Media Sites

- Twitter
  - More than 310 million active users
  - As with Facebook, users post personal information such as current status, photographs, contact information and conversations, but are limited to 140 characters per update
  - User can have profile and “tweets” completely public or lock “tweets” so that only approved users have access
  - Users “follow” other users

Top Social Media Sites

- Linked-In
  - 255 million worldwide users
  - Business networking site; users typically post career information and testimonials from colleagues regarding their work
  - Default provides limited public information; upon acceptance of a "connection" with another user, rest of profile becomes accessible.
  - Users "connect" with other users

Top Social Media Sites

- YouTube
  - 1 billion user visits each month
  - Video-sharing website on which users can upload, view, and share videos
  - Unregistered users can watch videos; registered users can upload unlimited number of videos
  - Over 6 billion hours of video are watched each month on YouTube; 100 hours of video are uploaded to YouTube each minute

Top Social Media Sites

- Instagram
  - 300 million monthly users
  - Allows users to share real-time photos and short videos while on the go
- Snapchat
  - 100 million monthly users
  - Text-, photo- and video-messaging application that allows users to send messages that (purportedly) will disappear in one to ten seconds after receipt
- Tumblr
  - Cross between a social networking site and a blog
  - Hosts more than 108 million separate blogs

Social Media and Lawyer Ethics

- Few Ethical Standards for Dealing with Social Media
  - San Diego County Bar Legal Ethics Committee Opinion 2011-02
  - State Bar of California Standing Committee on Professional Responsibility and Conduct Draft Formal Opinion Interim No. 10-0001

Publicly Available Info OK

- Publicly available information always ethical to obtain. Publicly available information is any unprotected information put on the Internet by a person, company, or third party which is accessible by anyone.
- No rules or statutes prohibiting accessing publicly available information; can access, read, and use such information without restriction
- Okay to Google
- Okay to access a represented party's public Facebook page because there is no contact or communication with the represented party

Where Things Get Sticky . . .

- To Friend or Not To Friend:
  - Act of "Friending" to gain access to another person's social media information is where ethical issues arise for attorneys.
  - May an attorney . . . .
    - Send a friend request to a represented party?
    - Direct another to send a friend request to a represented party?
    - Create or have someone else create a fake profile from which to send a friend request to a represented party?
    - Obtain information on a represented party through his or her client's access to the party's profile page?

“Friending” Represented Parties

- **RULE 2-100 - Communication With A Represented Party**
-
- (A) While representing a client, **a member shall not communicate directly or indirectly about the subject of the representation with a party the member knows to be represented by another lawyer in the matter**, unless the member has the consent of the other lawyer.
-
- (B) For purposes of this rule, a "party" includes:
- (1) An officer, director, or managing agent of a corporation or association, and a partner or managing agent of a partnership; or
- (2) An association member or an employee of an association, corporation, or partnership, if the subject of the communication is any act or omission of such person in connection with the matter which may be binding upon or imputed to the organization for purposes of civil or criminal liability or whose statement may constitute an admission on the part of the organization.
- (C) This rule shall not prohibit:
  - (1) Communications with a public officer, board, committee, or body; or
  - (2) Communications initiated by a party seeking advice or representation from an independent lawyer of the party's choice; or
  - (3) Communications otherwise authorized by law.

“Friending” Represented Parties

Is a “Friend” Request a contact that falls under CRPC 2-100’s prohibition against contacting a party to an action who is represented by counsel, i.e. is it:

1) A direct or indirect communication with a represented party, and
2) A communication about the subject of the representation?

How “Friending” Works

- When Friend Request sent on Facebook, by default it is accompanied by the message “[User] wants to be friends with you on Facebook.”

- Once Friend Request is accepted, the newly connected friends by default have all aspects to all parts of their new friend’s profile and information, unless the new friend limits their access.

To “Friend” Or Not to “Friend”

- Rule 2-100A does not prevent <u>all</u> attorney communications with a represented party, just those communications <u>about the subject of the representation</u>.

- A Friend Request does not mention subject of the representation – is there an issue?

To "Friend" Or Not to "Friend"

- Yes. SDCBA Opinion 2011-02 held that a Friend Request to a represented party is a violation of CRPC 2-100(A) even though the statement included in the Friend Request is innocuous in itself and does not refer to the subject of the representation.
- Basis for conclusion is that the motivation of the attorney to access information about the represented party would not have arisen outside of the representation; therefore, this motivation was sufficient to make the contact about the subject of the representation.

To "Friend" Or Not to "Friend"

- Committee determined that "Friending" is inherently different from accessing publicly available information in that "Friending" allows access to restricted information.
- Moral: Attorneys are allowed to view and access all unrestricted parts of a social media website, even a restricted one, but where a connection is required to access additional information, a request for a connection with a represented party violates CRPC 2-100(A).
- Includes Facebook, Google+, Linked-In, and some users of Twitter.

“Friending” Unrepresented Parties

- Committee determined that an attorney that sends a Friend Request to an unrepresented party without disclosing the reason for the connection request is in violation of their duty “to employ . . . those means only as are consistent with truth.” (Bus. & Prof. Code §6068(d).
- Reasoning: An attorney, or third party hired by the attorney, who fails to disclose the reason for the Friend Request is omitting a highly material fact – that the sole reason for the connection is to obtain information the party otherwise would not divulge had the party known the reason for the request.

Fake Profiles

- SDCBA implies, but does not explicitly state, that establishing or using a fake profile for the purpose of sending a connection request to a party to an action crosses the ethical boundary.
- Violation of attorney’s duty to use “means only consistent with the truth.”
- Violates terms of use for many social media websites
- Could be considered an act involving “moral turpitude, dishonesty, or corruption,” in violation of Bus. & Prof. Code §6106.

Fake Profiles

- Establishing fake profile is act of deception against the targeted party and is a misdemeanor under Bus. & Prof. Code §6128.
- Penal Code §528.5 prohibits impersonating another person via an internet website "for purposes of harming, intimidating, threatening, or defrauding another person."
- An attorney risks disbarment, fines, and even jail time for creating a fake profile to deceive a party into accepting a connection request.

"Friendly" Clients

- Can an attorney obtain information from his or her client obtained by means of a Friend Request?
- CRPC 2-100 not intended to prevent parties from communicating regarding the subject matter of the representation
- SDCBA Opinion 2011-02 expressly confirms that an attorney's client may send a Friend Request to an opposing party or witness and the attorney may advise him to do so.

“Friendly” Clients

- Attorney should NOT advise client to create a fake profile to send a Friend Request:
  - CRPC 3-210 prohibits an attorney from advising the violation of a law.
  - Violation of Penal Code §528.5

Connecting with Clients

- May an attorney send to or approve a connection request from:
  - An existing client?
  - A potential new client?

Connecting with Existing Clients

- No ethical rules prohibiting attorneys and clients from befriending each other on social networking websites.
- Attorney should think carefully about image they wish to project to clients.
- Risk of crossing boundary between an attorney's professional and private lives.

Connecting with Existing Clients

- Breeds familiarity between attorney and client that can lead to ethical violations or loss of attorney-client privilege.
- Client could post comments pertaining to representation that are exposed to a third-party.
- Ongoing connection may cause Client to believe representation is still continuing after formal representation terminates.

Connecting with Existing Clients

- Connecting may foster casualness that steps over line between attorney's professional and personal life.
- Connecting gives Client access to attorney's photos, family information, and recreational activities.
- Difficult to control flow of information once connected; privacy settings are crucial.
- Client may now consider himself more "friend" than client

Connecting with Potential Clients

- A communication under CRPC 1-400 is "any message or offer made by or on behalf of a member concerning the availability for professional employment of a member or a law firm directed to any former, present, or prospective client."
- Applies to attorney website information that relates to employment availability - including social media websites.
- Testimonials posted on social media websites by clients may violate CRPC 1-400, depending upon content.

Connecting with Potential Clients

Case finally over. Unanimous Verdict!
Celebrating tonight.

Connecting with Potential Clients

Another great victory in court today!
My client is delighted. Who wants to be next?

Connecting with Potential Clients

Won a million dollar verdict. Tell your friends and check out my website.

Connecting with Potential Clients

- An attorney needs to take care that his or her profiles on social media websites do not violate CRPC 1-400(D) prohibitions, either via his or her own posts or via a client's recommendation or testimonial posted on the website.
- Private profiles that an attorney does not use to contact clients do not need to comply with CRPC 1-400, but attorney needs to make sure site remains completely personal.

Connecting with Potential Clients

- A solicitation under CRPC 1-400 is a communication "concerning the availability for professional employment of a member or a law firm in which a significant motive is pecuniary gain; and which is delivered in person or by telephone or directed by any means to a person known to the sender to be represented by counsel in a matter which is a subject of the communication."
- A website is not a solicitation, even if it contains a function to email the attorney but is subject to professional responsibility standards governing attorney advertising. (State Bar Formal Ethics Opinion 2001-155.)

Connecting with Potential Clients

- Use of real-time social media communication features to attract new clients may violate CRPC 1-400.
- When Attorney posts information about his or her practice, even if only to "Friends," CRPC 1-400 may apply.
- Standards of CRPC 1-400 are not relaxed merely because compliance is difficult or awkward in social media setting.
- ABA Model Rule 7.3 includes real-time electronic contact, e.g. instant messaging discussion on Facebook or back and forth messaging on Twitter.

Connecting with Judges

- Contact between an attorney and judge on a social media website may pose an ethical violation.
- CRPC 5-300 prohibits an attorney from contact with a judge or judicial officer regarding a case pending before him or her.
- Contact via social media connection, even as innocuous as the judge "liking" a post the attorney makes on the attorney's profile about the case, can be considered ex parte contact in violation of CRPC 5-300.

Connecting with Judges

- An attorney should terminate any online connections they have with a judge or judicial officer during the period in which the attorney has cases pending before the judge or judicial officer.
- An attorney must be careful to avoid appearance of impropriety when initiating or maintaining a social media connection with a judge or judicial officer.

Connecting With Other Attorneys

- No prohibitions against an attorney connecting on social media with other attorneys.
- Existence of a social media connection with opposing counsel may negatively impact Client's level of trust in attorney
- Establish and monitor privacy settings to ensure that client communications when "friending" other attorneys.

Responding to Online Complaints

- Facebook, Yelp, and other websites allow users to post ratings and review of businesses on business profiles.
- Problem arises when attorney believes negative ratings or comments are inaccurate or unwarranted.
- Public response to negative comments could pose risk of exposing privileged information, in violation of Bus. & Prof. Code §6068(3)(1) and CRPC 3-100.

Responding to Online Complaints

- SFCBA Opinion 2014-1
  - An attorney is not ethically barred from responding generally to an online review by a former client if the matter has concluded **BUT** the attorney cannot disclose confidential information absent a waiver.
  - If matter is not concluded, it may be inappropriate for the attorney to provide any substantive response, even one that does not disclose confidential information.
- Nothing in statute or rules prohibits attorney from deleting post, if able.
- If attorney chooses to respond, cannot discuss substantive issues and should remain professional.

Navigating the Brave New World

- Remember that even in this new world, the same old ethical rules apply. California does not have "online" rules; the rules are still the same. What we have are ethics opinions on how those rules are applied in the online world.

Navigating the Brave New World

- Don’t blog about your own clients or cases, except to the extent that the information is unequivocally publicly available.

Navigating the Brave New World

- Do not make derogatory comments about clients, judges, court staff, or other counsel, even when posting “privately” on social media.

Navigating the Brave New World

- If you participate in question-and answer websites, use generic responses, avoid addressing highly specific fact situations and expressly state that your answer should not be considered legal advice. Use express cautionary language and disclaimers that you are not forming an attorney-client relationship in order to ensure that the user does not have a "reasonable expectation" that you are willing to enter into that relationship.

Navigating the Brave New World

- Become competent in technology. Know how social media works before you use it. Rule 3-110 requires lawyers to act competently, which arguably includes the integration of social media in an attorney's practice.

- ABA 20/20 Commission has proposed that Model Rule 1.1 on competence be amended to <u>require</u> lawyers not only to maintain competence in law and practice but also "in the benefits and risks associated with technology."

Navigating the Brave New World

- An excellent source of information on new technologies is the ABA Legal Technology Resource Center.

Navigating the Brave New World

- Know how each social media site shares information and how the privacy settings work for each site. Be aware that sites often can and do change their privacy settings without notice and understand that what is secure today may not be secure tomorrow.

Navigating the Brave New World

- Monitor social profiles regularly for factual accuracy, whether those profiles are third-party created or self-maintained.

Navigating the Brave New World

- Make sure you use disclaimers for all social media postings to prevent the inadvertent formation of an attorney-client relationship and to avoid the unauthorized practice of law in a different jurisdiction.
- Make sure the disclaimer is in sufficiently plain terms so as to defeat the user's reasonable belief that the lawyer is consulting confidentially with the user. Use a click-wrap disclaimer where possible.

Navigating the Brave New World

- Develop and implement a social media policy for every person in your employ. Otherwise, your staff's ethical violations will become your ethical violations.

Navigating the Brave New World

- Remember the Golden Rules:
  - Rule # 1: Like Mom said, if you can't say anything nice about anyone, don't say anything at all.
  - Rule #2: If you are going to violate Rule #1, don't post it online.

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ICICLES ON THE HEART:

ADVISING A CLIENT/TRUSTEE WITH UNCERTAIN CAPABILITIES AND TOWARD A FIDUCIARY STANDARD OF CAPACITY

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I. INTRODUCTION

A. Demographic Trends Increasing the Incidence of the "Fading Trustee"

1. The "greying" of America.

a) In 2011, 14% of the US population was over 65.[1]

b) Over the next 15 years, over 1,000 Californians will turn 65 every day.

c) The segment of California's population over 65 is expected to grow by over 20% over the next 5 years.

B. Some commentators assert that the oncoming decades will witness a transfer of about $12 trillion from those born in 1920s and 30s to the "baby boomers", and that the "boomers" are expected to transfer some $30 trillion in assets to their beneficiaries over the next 30-40 years in the U.S.[2]

C. Even though Americans are growing older at an increasing rate, most people want to remain trustee of their own trusts.

1. Many people are unable to recognize the often gradual decline in their own cognition and memory.

2. Sometimes family members notice a decline but are reluctant to raise the issue with the Trustee.

3. The estate planning attorney may recognize these issues with a client, but may hesitate to confront the client.

D. A challenge confronting planners is the absence of guidance in this area. Neither the statutory nor the case law has yet been required to confront this problem directly. As a result, practitioners are compelled to pull threads from other areas to answer these new questions. Inevitably, stresses will arise from the application of principles developed from other policy considerations and fact patterns. This tension will remain until the law catches up the facts.

II. BACKGROUND ON CAPACITY

A. The basic starting point for any mental capacity determination is the Due Process in Competence Determinations Act, Prob. Code, §§ 810 to 813, 1801, 1881, 3201, and 3204.

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[1] 2014-15 California Budget Proposal.

[2] Sarbjit Nahal and Beijia Ma, Bank of America investment Report

1. The literature contains a dearth of material directly on point that fully describes the facts and circumstances in which a person will be deemed incompetent pursuant to the DPCDA.

2. Marc B. Hankin, a participant in the drafting of the DPCDA, summarized the legislative history and operative terms of the statute. It "engrafts onto the law of legal mental competence the terminology used by today's science of the mind" and "largely codifies existing case law as it should be applied using state of the art forensic psychiatric assessment techniques regarding incapacity." Hankin, *A Brief Introduction to the Due Process in Competence Determinations Act: A Statement of Legislative Intent* (Winter 1995) Vol. 1, No. 4, Trust & Estates Quarterly 36-48.

3. Hankin foreshadowed the issues present in *Anderson v. Hunt* (2011) 196 Cal.App.4th 722 by commenting about the capacity standard applicable to trusts. He stated that the "testamentary data set is small (essentially who the testator and the testator's relatives are, what the testator owns, and who will take under the will), and only a peculiarly low operational level of mental function integrity is required" to execute a testamentary document.

4. The required capacity to contract, in contrast, involves a data set that "is obviously larger and more complex," requiring the mental functions set forth in section 811 to operate at a minimally acceptable level. Mr. Hankin observed that trusts have contractual features that weigh in favor of the contractual capacity standard, but also have a testamentary aspect that should be considered. He concluded that the law was unsettled and "trusts established by persons lacking contractual capacity are of very questionable validity." *Id.* at 42.

B. DPCDA codifies standards for a court to use in determining whether a person has the capacity to perform particular acts in specific contexts. The statutory presumption continues common law that an individual is "competent" until proven otherwise.

C. DPCDA does not authorize a mere diagnosis of a physical or mental disorder as the sole basis to establish lack of capacity. A judicial determination of incapacity must be based on evidence "of a deficit in one or more of the person's mental functions." The code requires a finding of significant impairment with respect to "the type of act or decision in question," and the court may take into consideration "the frequency, severity, and duration of periods of impairment."[3]

---

[3] **Probate Code § 810**

(a) For purposes of this part, there shall exist a rebuttable presumption affecting the burden of proof that all persons have the capacity to make decisions and to be responsible for their acts or decisions.

(b)A person who has a mental or physical disorder may still be capable of contracting, conveying, marrying, making medical decisions, executing wills or trusts, and performing other actions.

D. Probate Code §§ 810-813 contain special rules governing the evidence that must be adduced whenever it is sought to prove that a person lacks the capacity to make a particular decision or do a particular act.

E. Those rules provide, among other things, that a judicial determination that a person is totally without understanding, of unsound mind, or suffers from one or more mental deficits so substantial that, under the circumstances, the person should be deemed to lack the legal capacity to perform a specific act, should be based on evidence of a "deficit" in one or more of the person's mental functions rather than on a diagnosis of a mental or physical disorder. *Prob. Code §§ 810(c), 811.*

F. *Prob. Code § 812* provides that a person lacks the capacity to make a decision unless the person has the ability to communicate the decision (verbally or by any other means) and to understand and appreciate, to the extent relevant, all of the following:

1. The rights and responsibilities created by or affected by the decision;

2. The probable consequences for the decision-maker and, when appropriate, the persons affected by the decision; and

3. The significant risks, benefits, and reasonable alternatives involved in the decision.

G. The requirements specified in Prob. Code § 812 do not apply when otherwise provided by law, including the statutory and decisional law of testamentary capacity.

H. Prob. Code § 811 addresses the evidence that must support a determination that a person is of unsound mind or lacks the capacity to make a decision or do an act, and evidence of a correlation between the deficit and the decision or act in question.

I. Under Prob. Code § 811, a determination that a person is of unsound mind or lacks the capacity to make a decision or do a certain act, including the incapacity to execute a will, must be supported by evidence of a deficit in at least one of the following mental functions:

1. Alertness and attention, including, but not limited to, the following:

   a) Level of arousal or consciousness;

   b) Orientation to time, place, person, and situation;

(c) A judicial determination that a person is totally without understanding, or is of unsound mind, or suffers from one or more mental deficits so substantial that, under the circumstances, the person should be deemed to lack the legal capacity to perform a specific act, should be based on evidence of a deficit in one or more of the person's mental functions rather than on a diagnosis of a person's mental or physical disorder.

c) Ability to attend and concentrate.

2. Mental health professionals describe four levels of alertness (or consciousness): alert, drowsy, stuporous, or comatose. Stupor is defined as an inability to remain conscious unless repeatedly aroused.

a) If an individual is less than alert, the ability to pay attention and other types of mental functioning will likely be compromised.

b) Orientation to time (e. g., date, year) is generally the most sensitive to organic brain dysfunction.

c) Disorientation to person, place, and situation often occur together. Thus, a client who does not understand he or she is in an attorney's office (place) may well not grasp being with an attorney (person) or the nature of the work to be done with the attorney (situation).

3. Information processing, including, but not limited to, the following:

a) Short- and long-term memory, including immediate recall;

b) Ability to understand or communicate with others, either verbally or otherwise;

c) Recognition of familiar objects and familiar persons;

d) Ability to understand and appreciate quantities;

e) Ability to reason using abstract concepts;

f) Ability to plan, organize, and carry out actions in one's own rational self-interest;

4. Memory is a mental function listed in the domain of information processing. An attorney should be concerned when a client has a memory deficit in the following instances: (1) a report of forgetfulness by the client, family, or friends, (2) forgetfulness that becomes apparent during the consultation, and (3) over-reliance by the client on others to answer questions.

5. Impaired memory is a cardinal feature of a dementing disorder such as Alzheimer's disease.

6. The Probate Code refers to "short- and long-term memory, including immediate recall."

a) Immediate recall refers to an individual's ability to register information and repeat it back at once. If new information does not register, it will not be stored for recall.

b) Short-term memory (STM) refers to a person's ability to remember relatively new information--e. g., data presented ten minutes previously. In the realm of health care for example, the patient who cannot assimilate new information about a proposed medical treatment may be unable to give informed consent.

c) In the course of dementia, STM is usually affected before long-term memory (LTM).

d) LTM refers to the ability to recall old information, such as one's birth date, names of relatives, and widely-known historical facts. An example of an LTM deficit interfering with decision-making is the client who wishes to bequeath assets but does not remember either the assets or the potential beneficiaries.

7. Thought processes; deficits in these functions may be demonstrated by the presence of the following:

a) Severely disorganized thinking;

b) Hallucinations;

c) Delusions;

d) Uncontrollable, repetitive, or intrusive thoughts.

8. A *hallucination* is defined as follows: "A perceptual distortion for which there is no external stimulus."

9. Hallucinations may occur in various disorders, including schizophrenia and dementia, and they may occur in any one of the five senses. In schizophrenia for example, a person may hear a voice commanding that personal belongings be given away to strangers. The individual would most likely be incapacitated on the basis of the hallucinations.

10. A delusion is defined as a *fixed, false belief that is not amenable to reality testing.*

a) There are various kinds of delusions, including grandiose, persecutory, and jealous.

b) A demented person may have a jealous delusion that interferes with capacity, as in the following hypothetical: An elderly gentleman with severe

Alzheimer's disease resides in a nursing home. He sees his wife of many years speak once to a male nursing attendant. On this basis, he develops the totally unfounded and irrational belief that she is having an affair with the attendant, and he decides to divorce her.

11. *Ability to modulate mood and affect.* Deficits in this ability may be demonstrated by the presence of a pervasive and persistent or recurrent state of euphoria, anger, anxiety, fear, panic, depression, hopelessness or despair, helplessness, apathy or indifference, which is inappropriate in degree to the individual's circumstances.

a) According to the American Psychiatric Glossary, mood refers to "a pervasive and sustained emotion." A mood disturbance can adversely impact a person's judgment. For example, someone with a clinical depression may refuse medical treatment due to feelings of worthlessness, helplessness, and guilt.

b) The psychiatric term "affect" (with the accent in pronunciation placed on the first syllable) refers to how emotion is expressed. Affect may be disturbed in various ways, such as being blunted, inappropriate, or unstable.

c) In dementia for example, there may be an overall blunting of emotional expression. Indifference in someone with dementia in the face of a life-threatening medical condition is an example of a disturbance of affect interfering with competence.

J. A deficit in the mental functions listed above may be considered only if the deficit, by itself or in combination with one or more other mental function deficits, significantly impairs the person's ability to understand and appreciate the consequences of his or her actions with regard to the type of act or decision in question. Prob. Code § 811(b).

K. Nevertheless, the presence of mental deficits may be indicated by telltale signs other than the features mentioned above. For example, someone with dementia may demonstrate the following: a look of befuddlement, trouble grasping explanations, lack of spontaneity, reduced amount of speech, word-finding difficulty (e. g., calling a chair a "thing"), and vagueness. Someone with schizophrenia may be disheveled, have a strange demeanor, and have bizarre beliefs. Someone with depression may be socially withdrawn, speak and move slowly, and have oppressive negative thoughts.

L. In determining whether a person suffers from a deficit in mental function so substantial that the person lacks the capacity to do a certain act, the court may take into consideration the frequency, severity and duration of periods of impairment. *Prob. Code § 811(c).*

M. The mere diagnosis of a mental or physical disorder will not be sufficient in and of itself to support a determination that a person is of unsound mind or lacks the capacity to do a certain act. *Prob. Code § 811(d).*

N. These rules do not directly amend or revise the Probate Code standard for determining when a person is not mentally competent to make a will. Rather, they prescribe a minimum level of evidence that must be adduced in any effort to establish that a person is of unsound mind or lacks the capacity to make a decision or do a certain act. To this extent, they provide important guidelines that must be considered whenever it is necessary to determine if a person lacks capacity. *Prob. Code § 811(a), (e).*[4]

O. The competency of person is thus dependent on circumstances and the action in question:

1. Even if a mental function deficit is present, there must be evidence of a correlation between the deficit(s) and the capacity required for the specific act or decision in question. See Probate Code §811(a).

2. In the context of a court proceeding, which may arise from any transaction, act, or decision

a) A deficit under Probate Code §811(a) may be considered only if the deficit, by itself or in combination with one or more other mental function deficits, significantly impairs the person's ability to understand and appreciate the consequences of his or her actions with regard to the type of act or decision in question (Probate Code §811(b));

b) In determining whether a person suffers from a deficit in mental function so substantial that the person lacks the capacity to do a certain act, the court may consider the frequency, severity, and duration of periods of impairment (Probate Code §811(c)); and

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[4] **CA Probate Code § 812**

Except where otherwise provided by law, including, but not limited to, Section 813 and the statutory and decisional law of testamentary capacity, a person lacks the capacity to make a decision unless the person has the ability to communicate verbally, or by any other means, the decision, and to understand and appreciate, to the extent relevant, all of the following:

(a) The rights, duties, and responsibilities created by, or affected by the decision.

(b) The probable consequences for the decisionmaker and, where appropriate, the persons affected by the decision.

(c) The significant risks, benefits, and reasonable alternatives involved in the decision.

c) Deficits in alertness and attention or in the ability to understand or communicate with others under Probate Code §811(a) may indicate that the person lacks the ability to communicate the decision and understand and appreciate the rights, duties, and responsibilities created or affected by the decision and the risks, benefits, and reasonable alternatives involved in the decision, as required by Probate Code §812.

P. Informed Consent and the Capacity to Make Fiduciary Decisions[5]

1. Hundreds of thousands of Americans each year sign pieces of paper "voluntarily" admitting themselves into hospitals. Doctors often treat patients who have dubious capacity and do not object to treatment without assessing capacity or considering alternative decision making. Lack of capacity promises to be a growing issue as the population ages because the risk of dementia increases exponentially with age.

2. Capacity is critical because the doctrine of informed consent requires that the client have capacity to consent. This requirement is overwhelmed by forces pulling in the opposite direction. If the client agrees to do what the attorney may believe is in the client's best interests, the lawyer may look no further and simply presume capacity.

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[5] **CA Probate Code § 813**

(a) For purposes of a judicial determination, a person has the capacity to give informed consent to a proposed medical treatment if the person is able to do all of the following:

(1) Respond knowingly and intelligently to queries about that medical treatment.

(2) Participate in that treatment decision by means of a rational thought process.

(3) Understand all of the following items of minimum basic medical treatment information with respect to that treatment:

(A) The nature and seriousness of the illness, disorder, or defect that the person has.

(B) The nature of the medical treatment that is being recommended by the person's health care providers.

(C) The probable degree and duration of any benefits and risks of any medical intervention that is being recommended by the person's health care providers, and the consequences of lack of treatment.

(D) The nature, risks, and benefits of any reasonable alternatives.

(b) A person who has the capacity to give informed consent to a proposed medical treatment also has the capacity to refuse consent to that treatment.

Q. The DPCDA broadly covers the capacity of persons who have a mental or physical disorder to perform all types of actions.

1. In the case of *In re Marriage of Greenway* (2013) 217 Cal. App. 4th 628, Joann Greenway appealed from the lower court's ruling that her husband, Lyle Greenway, was mentally competent to obtain a divorce from her after 48 years of marriage. Joann objected to dissolving the marriage or dividing the estate, which was valued at several million dollars. Lyle argued that irreconcilable differences necessitated such dissolution. Joan countered that 76 year old Lyle was mentally incompetent to maintain a dissolution action. Based on extensive testimony and written arguments from all parties the trial court concluded that Lyle was mentally capable of making a reasoned decision to end his marriage.

2. On appeal the trial court's determination that Lyle was mentally capable of making a reasoned decision to end his marriage was affirmed notwithstanding the fact that the testifying experts agreed that Lyle had dementia. The proper question was whether his impairment was such that he no longer had the capacity of making a reasoned decision to end his marriage. In analyzing conflicting arguments, the *Greenway* court determined that a person's mental capacity is fact specific, and the level of required mental capacity changes depending on the issue at hand.

3. The *Greenway* opinion did make clear that the level of dementia was not the factual issue being decided by the trial court. It was not a conservatorship proceeding. The sole issue before the court was whether or not Lyle had the required level of mental capacity, despite his diagnoses of dementia, to end the marriage.

R. The DPCDA expressly states that it broadly covers the capacity of persons to perform all types of actions, including, but not limited to contracting, conveying, executing wills and trusts, marrying and making marriage decisions. *Greenway* is thus consistent in categorizing a decision to divorce along with the other enumerated decisions.

III. DUTY TO INVESTIGATE LACK OF CAPACITY

A. An attorney who prepares a will for a testator who lacks capacity does so at his or her own risk. Although no California case or ethical opinion has been found in which an attorney has been condemned for preparing a will for an incompetent testator, the courts have commented approvingly when attorneys have refused to do so. *See Estate of Morgan* (1964) 225 Cal. App. 2d 156, 160-161, 169, 37 Cal. Rptr. 160; *Estate of Halbert* (1947) 80 Cal. App. 2d 666, 671, 182 P.2d 266 . The ethical committee of one local bar association has expressed the opinion that an attorney should not represent a client when the representation can be of little or no value to the client. L.A. County Bar Association Formal Opinion No. 448 (1987). The attorney, however, has no duty to beneficiaries under a will to determine and document evidence regarding the testamentary capacity of a

client. See e.g. *Moore v. Anderson Zeigler Disharoon Gallagher & Gray*, (2003) 109 Cal. App. 4th 1287, 135 Cal. Rptr. 2d 888.

B. An attorney who has reason to suspect that a client/fiduciary's capacity may be questioned should make some inquiries in the matter. The extent of these inquiries will depend on various factors, including the fiduciary's apparent condition. If the circumstances of the representation raise doubts as to capacity and satisfactory medical evidence is otherwise unavailable, the attorney should make appropriate inquiries.

C. The Functional Assessment Staging Test ("*FAST*") is a well-regarded measure of the course of Alzheimer's disease in the scientific literature. (Reisberg, *Functional Assessment Staging* (1988) 24 Psychopharmacology Bulletin 653, 653-659 (*"FAST"*)). FAST defines seven stages of Alzheimer's disease, beginning with "normal aging" and progressing to "severe dementia." The FAST tool is used by mental health professionals to determine if changes in a patient's condition are due to Alzheimer's disease or another condition. A passing knowledge of this test may assist practitioners dealing with a fading trustee.

D. The presence of mental deficits may be indicated by other telltale signs. For example, someone with dementia may demonstrate the following: a look of befuddlement, trouble grasping explanations, lack of spontaneity, reduced amount of speech, word-finding difficulty (e.g., calling a chair a "thing"), and vagueness. (Plassman, et al., *Prevalence Of Dementia In The United States: The Aging, Demographics, and Memory Study*, (2007) 29 Neuroepidemiology 125)

E. Nevertheless, an individual may be able to disguise a mental deficit. For example, someone with mild-to-moderate Alzheimer's disease may hide intellectual impairments well, and there may be supportive friends or family who respond for the individual, thus obscuring deficits. In addition, many people with dementia retain an appearance of physical well-being and are quite sociable, thereby belying cognitive dysfunction.

F. The attorney may, for example, ask the fiduciary to describe the trust assets, to identify the beneficiaries, and to name and describe his or her relationship to the beneficiaries or related professionals. The attorney may also determine whether the fiduciary attends to his or her personal affairs and is capable of discussing business matters in a coherent fashion. *See Estate of Doty* (1949) 89 Cal. App. 2d 747, 751, 201 P.2d 823. If the attorney harbors doubts on the question of capacity, it may be appropriate to direct inquiries to other persons, including the fiduciary's physicians, friends, and relatives.

G. In short, the attorney does have a duty to the client/fiduciary to make some kind of inquiry and determination regarding that client's capacity in order to provide the client with effective legal services.

IV. HOW AND WHETHER TO DETERMINE "COMPETENCY" FOR THE FADING TRUSTEE

A. A settlor-trustee's capacity arises in the context of Probate Code § 15800's requirement that "the person holding the power to revoke the trust is competent."

B. Section 15800 uses the term "competent," which implies not only the power to revoke but also the mental capacity to do so.

1. This mental capacity involves "decisional capacity" (e.g., to execute a trust, enter into a contract, transfer property, sign a directive) at the time the decision is made or action taken.

2. This faculty is distinct from "functional capacity" (e.g., to take care of personal needs, resist fraud or undue influence), which is sustained over a period of time.

3. Unlike susceptibility to undue influence, which can have varying degrees, both decisional and functional capacity are threshold concepts: either the person is or is not "competent." *See* Streisand & Spar, *A Lawyer's Guide to Diminishing Capacity and Effective Use of Medical Experts in Contemporaneous and Retrospective Evaluations*, 33 ACTEC J 180 (Winter 2008).

C. California case law historically has distinguished between testamentary capacity and contractual capacity. This distinction remains useful for discussion of trusts because both tests apply. *In Marriage of Greenway* (2013) 217 CA4th 628, 639, the court referred to "multiple and overlapping" statutes found in the Probate Code, Welfare and Institutions Code, Civil Code, and Family Code and stated: "After reviewing the relevant case law, we conclude mental capacity can be measured on a sliding scale, with marital capacity requiring the least amount of capacity, followed by testamentary capacity, and on the high end of the scale is the mental capacity required to enter contracts."

V. CASE LAW REGARDING TRUSTEE CAPACITY

A. While *Greenway* is helpful, there is little applicable judicial or statutory authority that specifically deals with the scenario of the fading trustee. Therefore practitioners must look to other areas of the law to determine whether those concepts can be adapted to this new problem.

B. California Trust Law provides that a trustee of a revocable trust owes fiduciary duties only to the person who holds the power to revoke (usually the settlor) and not to the beneficiaries, "[e]xcept to the extent that the trust instrument otherwise provides or where the joint action of the settlor and all beneficiaries is required." Probate Code §§15800, 16069(a).

C. Previously, the understanding of these statutes resulted in the following rules:

1. Only the settlor may therefore assert a breach of trust.

2. The trustee need always account only to the settlor.

3. The trustee is exempt from liability if the settlor signed a directive in writing.

4. Claims for breach of trust die with the settlor or become the property of the settlor's estate.

D. Early signs of a change in paradigm came in the cases of *Evangelho v Presoto* (1998) 67 Cal.App.4th 615, and *Esslinger v Cummins* (2006) 144 Cal.App.4th 517.

E. Recently the landmark cases of *Estate of Giraldin* (2012) 55 C4th 1058 and *Drake v Pinkham* (2013) 217 Cal.App.4th 400 have further eroded the notion that trustee only owes a duty to the settlor of a revocable trust.

F. *Giraldin* - The issue in *Giraldin* was "whether, after the settlor [of a revocable trust] dies, the beneficiaries have standing to sue the trustee for breach of the fiduciary duty committed while the settlor was alive and the trust was still revocable." *Giraldin* at 1062.

G. Case Summary:

1. Settlor created a revocable trust in early 2002 and designated his son to serve as the trustee. The trust provided that Settlor was the only beneficiary during his lifetime, and in the event of Settlor's incapacity, the trustee was to make liberal distributions for Settlor's needs, and that the rights of remainder beneficiaries shall be of no importance. The trust also contained a provision that during Settlor's lifetime, "the trustee shall have no duty to provide any information regarding the trust to anyone other than [Settlor]."

2. Just prior to creating his trust, Settlor entered into an agreement to invest 2/3rds of his fortune in SafeTzone, a company owned by his trustee son. Settlor's investment in SafeTzone ultimately became an asset of the trust administered by the trustee. By the time Settlor died in 2005, the SafeTzone investment was essentially worthless, prompting the trustee's siblings, as trust remainder beneficiaries, to file suit against him for breach of fiduciary duties.

3. The case eventually wound its way up to the California Supreme Court which granted the remainder beneficiaries petition for a limited review of whether they had standing to sue the trustee for breaches of fiduciary duty committed during the period of revocability.

H. *Giraldin* Court Holdings:

1. The court held that a while the trust is revocable, the trustee owes no fiduciary duties to the remainder beneficiaries, but solely to the settlor.

2. The fact that the trustee owes no duty to the remainder beneficiaries while the trust remains revocable does not retroactively change after the settlor dies.

3. Had the beneficiaries brought the action only for breach of duty owed to them, the court would have dismissed the case for lack of standing.

4. Nevertheless, the court noted that a substantial thrust of the action and the trial court's order concerned an alleged breach of the trustee's fiduciary duty *toward the settlor* during his lifetime.

5. Using this analysis, the court held that the remainder beneficiaries did have standing to claim a violation of the trustee's duty to the settlor.

6. This standing was limited to situations in which the violation of fiduciary duty to the settlor harmed the beneficiaries.

7. The *Giraldin* court made clear that while contingent remainder beneficiaries cannot, under Probate Code §15800, request an account or pursue an action for breach of trust during the period the settlor is alive and competent they can pursue such an action when their interests vest, typically on the settlor's death. The action for breach of trust cannot be for any alleged duty the trustee owed to the contingent beneficiaries during the settlor's lifetime and competency, but rather "to assert a breach of fiduciary duty the trustee owed to the settlor to the extent that breach harmed the beneficiaries' interests." *Giraldin* at 1068.

8. If Probate Code section 15800 prevents a beneficiary from contesting a revocable trust when the settlor is competent, does that mean that a settlor must be determined to be "incompetent" before a beneficiary can bring a contest during a settlor's lifetime? In addition, what happens if a beneficiary, believing a settlor to be incompetent, waits until after the settlor's death to bring a contest? These issues were addressed in *Drake v Pinkham*.

I. *Pinkham*:

1. Settlor created a revocable trust that was called into question by her beneficiary Daughter in litigation during the settlor's lifetime.

2. Although no finding of incompetency was made at the time – the litigation was settled – the fact that Daughter had alleged that Settlor was incompetent came back to haunt her when she later contested the Settlor's trust amendments after the settlor's death.

3. The trial court found that Daughter was aware of the existence and terms of the trust amendments at the time of the earlier litigation and that the allegations of incompetency meant that Probate Code section 15800 did not prohibit Daughter from contesting the amendments at that time. The trial court held that by waiting

until after the settlor's death to bring a contest, the beneficiary had forfeited her right to contest the amendments under the doctrine of laches.

4. On appeal the Court of Appeal upheld the trial court's reasoning and stated that while it is true that Probate Code sections 17200 and 15800 limit the petition rights of beneficiaries, a beneficiary lacks standing to challenge a trust only so long as the person holding the power to revoke the trust is competent. The Drake court determined it was not necessary that incapacity be established before a beneficiary challenges a trust; the mere allegation of incapacity seemingly takes the matter outside of the terms of section 15800. The prior allegation by Daughter of Settlor's incapacity apparently gave her standing to challenge the amendments of which she was fully aware. That she had the burden of proving incapacity to maintain standing to pursue her claims was surprisingly ***not*** a valid excuse for her delay. The fact that there were mere allegations of incapacity, as opposed to a formal finding, did not prevent the *Drake* court from finding Daughter's claims were no barred by the equitable doctrine of laches.

5. *Drake* seems to stand for a "better safe than sorry" approach to dealing with potential claims that beneficiaries of revocable trusts have. Oftentimes trust and estate litigators will follow an "allege everything under the sun" approach in pleadings in an attempt to gain leverage in a case. This particular approach backfired for the beneficiary in *Drake*. The law may continue to evolve when addressing the rights of contingent beneficiaries of revocable trusts.

J. The case of *Anderson v. Hunt* (2011) 196 Cal.App.4th 722 picked up on the "sliding scale" language of determining competence from *Greenway*, and this time applied it testamentary capacity.

K. *Anderson* Case Summary:

1. Wayne Andersen and his wife Harriett established a family trust in 1992 that identified their two children, Stephen and Kathleen, as the sole beneficiaries after their deaths. Harriett died in 1993. Before Harriett died, Wayne developed a close personal relationship with Pauline Hunt. In 1996, Wayne amended his trust to name Pauline as his successor trustee in the event of his incapacity or death.

2. Though Wayne and Pauline never married, he ultimately favored her in his estate plan. Wayne suffered a stroke in May 2003 and thereafter moved into Pauline's home where he lived until his death in April 2006.

3. In 2003 and 2004, after moving in with Pauline, Wayne executed the four challenged trust amendments. In the May 2003 amendment, Wayne left a 60 percent portion of his estate to Pauline, with the remaining 40 percent going to Stephen, Kathleen and a grandchild. In the November 2003 amendment, Wayne provided that if Pauline predeceased him, her daughter would receive 25 percent of the trust assets, with Stephen, Kathleen and the grandchild dividing the remaining

75 percent, and further directed the trustee to sell his residence and not allow his children and grandchild to purchase it. In the July 2004 amendment, Wayne eliminated his grandchild as a beneficiary.

4. Wayne also opened several joint tenancy accounts with Pauline after he moved in with her, the largest account holding over $200,000 that he inherited from his aunt in September 2005. Further, in October 2003, he executed a change of beneficiary designation form for two whole-life insurance policies, naming Pauline as his first beneficiary and his children as subsequent beneficiaries.

5. The trial court invalidated the four trust amendments on the grounds of lack of mental capacity and/or undue influence. The court also invalidated the joint tenancy accounts that Wayne and Pauline created after his stroke, as well as the change of beneficiary on the life insurance policies.

6. California courts have not applied consistent standards in evaluating capacity to make or amend a trust. *Anderson, supra,* 196 CA4th at 729.

7. Testamentary capacity, when applicable to trusts, is the same standard set forth in Probate Code §6100.5 and as developed in the case law pertaining to wills. 196 Cal.App.4th at 731.

8. The general capacity standards of Probate Code §§810-812 apply to making various kinds of decisions, transact business, and enter into contracts (196 Cal.App.4th at 728), but these provisions do not relate solely to contractual capacity and include testamentary capacity. 196 Cal.App.4th at 730.

9. "In view of the amendments' simplicity and testamentary nature, we conclude that they are indistinguishable from a will or codicil." 196 Cal.App.4th at 731.

L. The *Anderson* court stated that it is appropriate to look at Probate Code §6100.5 to determine when a person's mental deficits are sufficient to allow a court to conclude that the person lacks the ability "to understand and appreciate the consequences of his or her actions with regard to the type of act or decision in question." §811(b). The court held that while section 6100.5 is not directly applicable to determine competency to make or amend a trust, it is made applicable through section 811 to trusts or trust amendments that are analogous to wills or codicils.

M. The first case to address the new Undue Influence regime was *Lintz v. Lintz (2014)* 222 Cal.App.4th 1346.

1. The *Lintz* court based its decision on an *Anderson* sliding-scale standard of capacity analysis. It found that the contractual standard should apply.

2. The *Lintz* court did not analyze the new standards of Undue Influence, but merely stated that its decision was unaffected by the change in the law.

3. "While this legislation [AB 140], effective January 1, 2014, does not affect our analysis, it eliminates any doubt that the two standards are now the same. Although the new reference to "excessive persuasion" may not be entirely clear, perhaps calling to mind Aristophanes' Lysistrata, the Legislature declared that the newly applied definition is not intended to supersede or interfere with the common law meaning of undue influence" *Lintz* at 13565, Footnote 3.

4. *Lintz* affirmed that Family Code §721 shifts the burden of proof of undue influence with regards to transactions between spouses.

5. The *Lintz* court noted: In property-related transactions between spouses, Family Code section 721, subdivision (b) "imposes a duty of the highest good faith and fair dealing on each spouse . . . ." This duty stems from the "general rules governing fiduciary relationships which control the actions of persons occupying confidential relations with each other," prohibiting each spouse from taking "any unfair advantage of the other." Thus, " '[i]f one spouse secures an advantage from the transaction, a statutory presumption arises under section 721 that the advantaged spouse exercised undue influence and the transaction will be set aside.' "An advantage results to one spouse when that spouse gains or when the other spouse is hurt by the transaction. A spouse obtains an advantage when the "spouse's position is improved, he or she obtains a favorable opportunity, or otherwise gains, benefits, or profits. The presumption is rebuttable; the spouse advantaged by the transaction must establish that the disadvantaged spouse acted freely and voluntarily, with " ' "full knowledge of all the facts, and with a complete understanding of the effect of the" transaction.' "

VI. Toward a Fiduciary Capacity Standard

A. A threshold issue that will confront the court determining whether a trustee's lack of capacity merits removal will be application of the appropriate standard under DPCDA's sliding scale. *Greenway;*[i] *Anderson*[ii] and *Lintz*[iii] all refer to the sliding scale. All three cases agree that testamentary capacity is a lower standard than contractual capacity.

B. Where on this scale does a trustee's fiduciary duty "to administer a trust in accordance with its terms"[iv] fall? The obligations to administer a trust require greater capacity than to execute a will; is that capacity less than that required to execute a contract? How can a trustee fulfill "the honor of a punctilio the most sensitive"[v] with anything less than the highest level of capacity? Indeed, does not the sliding scale of DPCDA extend *above* contractual capacity to reach the greater capacity to serve as a fiduciary?

C. The statutes and case law impose substantial obligations on a trustee. Failure to comply with those standards creates substantial liability exposure for the breaching fiduciary. These

standards make no allowance for a trustee's diminishing capacity. An aggrieved beneficiary may argue that a trustee who continues to serve despite his or her diminishing capacity has *prima facie* breached his or her several fiduciary duties.

D. The assumption underlying the recent cases has been that contractual capacity is the highest rung of the sliding scale. The three enunciated categories differ starkly from a trusteeship: none involves a fiduciary relationship. Until persons marry, no fiduciary relationship exists between them. A testator or settlor has no fiduciary duty to the objects of his or her bounty. The essence of executing a contract is the arms-length transaction, and protecting one's own self-interest, the antithesis of a fiduciary relationship.

E. A fiduciary is responsible for the best interest of another. Excusing a fiduciary's breach due only to a level of diminished capacity ignores the entire jurisprudence applicable to trustees. A rational analysis leads to the conclusion that acting for another imposes a duty of greater awareness and responsibility, and therefore the necessary capacity must be higher. The imaginative lawyer who argues this first case before the Court of Appeal may well be arguing that contractual capacity is not the final stop on DPCDA's sliding scale.

VII. PROCEDURES FOR REMOVING A TRUSTEE WITH UNCERTAIN CAPACITY (RESIGNATION, REMOVAL PURSUANT TO TRUST INSTRUMENT, REMOVAL BY COURT ORDER)

A. *Fading Trustee as Client vs. Fading Trustee as Opposing Party.* There is often a tension between the attorney wanting to do what is best for a fading settlor-trustee and the professional and ethical duties that the attorney owes to that client. If the fading trustee in question is the client, resignation is by far the most palatable solution to avoid controversy and liability. If the fading trustee is not the client, then the attorney will need to consider removal pursuant to the trust instrument or removal pursuant to court order.

B. *Resignation* – When an attorney has doubt about a client's capacity, referring the client to an expert in mental illness may be helpful. The challenge will be to persuade the client to submit to the examination. The assistance of family members will be indispensable as there are a number of ethical limitations that an attorney can employ in encouraging a fading trustee to resign.

C. *Ethical Issues Surrounding Encouraging the Fading Trustee to Resign* - Although almost all states have adopted Model Rules of Professional Conduct 1.14, and many states have now amended their rules to authorize an attorney to take reasonable steps to protect an impaired client, California has no rule regarding the representation of a client with diminished capacity.

1. Model Rule 1.14. (Client with Diminished Capacity) provides that "When a client's capacity to make adequately considered decisions in connection with a representation is diminished, whether because of minority, mental impairment or

for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client."

2. Model Rule 1.14 also provides that when the lawyer reasonably believes that the client has diminished capacity, is at risk of substantial physical, financial or other harm unless action is taken and cannot adequately act in the client's own interest, the lawyer may take reasonably necessary protective action, including consulting with individuals or entities that have the ability to take action to protect the client and, in appropriate cases, seeking the appointment of a guardian ad litem, conservator or guardian.

3. Information relating to the representation of a client with diminished capacity is protected by Model Rule 1.6. When taking protective action pursuant to paragraph (b), the lawyer is impliedly authorized under Rule 1.6(a)[6] to reveal information about the client, but only to the extent reasonably necessary to protect the client's interests.

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[6] Model Rule 1.6:

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;

(6) to comply with other law or a court order; or

(7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

D. *California Rules*. California Business and Professions Code (*Bus & Prof C*) §6068(e) provides that it is the duty of the attorney "[t]o maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."

1. A member shall not reveal information protected from disclosure by Bus & Prof C §6068, subdivision (e) (1) without the informed consent of the client, or as provided in paragraph (b) of the rule.

2. Subparagraph (b) provides that "A member may, but is not required to, reveal confidential information relating to the representation of a client to the extent that the member reasonably believes the disclosure is necessary to prevent a criminal act that the member reasonably believes is likely to result in death of, or substantial bodily harm to, an individual."

3. Before revealing confidential information to prevent a criminal act as provided in paragraph (b), a member shall, if reasonable under the circumstances:

a) make a good faith effort to persuade the client: (i) not to commit or to continue the criminal act or (ii) to pursue a course of conduct that will prevent the threatened death or substantial bodily harm; or do both (i) and (ii); and

b) inform the client, at an appropriate time, of the member's ability or decision to reveal information as provided in paragraph (b).

c) In revealing confidential information as provided in paragraph (b), the member's disclosure must be no more than is necessary to prevent the criminal act, given the information known to the member at the time of the disclosure.

d) A member who does not reveal information permitted by paragraph (b) does not violate this rule.

4. California Ethics Opinion 1989-112

a) Issue: May an attorney institute conservatorship proceedings on a client's behalf, without the client's consent, when the attorney has concluded the client is incompetent to act in his best interest? No.

b) The attorney must maintain the client's confidence and trust, even though the attorney will be torn between a duty to pursue the client's desires (including protecting his secrets) and a duty to represent his interests, which may best be served by instituting a conservatorship. While the attorney will not fall below the level of competence required by simply continuing the representation for which he or she was retained and avoiding filing a

conservatorship for the client, withdrawal may be appropriate or even mandatory if the client's conduct impedes the attorney's ability to effectively carry out the duties for which he or she was retained.

c) Analogous parallels can be drawn when representing a client who is a settlor-trustee with declining capacity.

d) The California is view that the attorney is an advocate and a confidant, not a mental health professional who is trained to make a diagnosis. This perspective is what makes this representation challenging.

5. Despite other states' efforts to give attorneys more latitude in dealing proactively with clients with diminished capacity, California law currently circumscribes the attorney's ability to take such actions.

C. *Removal Pursuant to Trust* - A trustee may be removed according to the terms of a trust instrument. Probate Code §15642.

1. Trust instruments often grant one or more persons the power to remove an incumbent trustee, sometimes for specified reasons or on specified contingencies, and sometimes for no reason at all.

2. Such power "allows removal without court proceeding" if exercise of the power conforms to valid requirements or limitations imposed by the trust. Restatement of the Law Third (Trusts) §37.

3. An important case on removal pursuant to a trust directive is *Rands v. Rands* (2009) 178 Cal.App.4th 907, 909.

4. In *Rands*, the trust provided that it was "irrevocable and unamendable" when settlor was unable "to act rationally and prudently in his or her own best interests financially" as determined by court order or certificates of two licensed physicians.

5. Two such physicians declared that the settlor was incompetent and the court upheld the provisions in the trust that blocked him from revoking the trust.

6. Although *Rands* illustrates the successful use of the standard "incapacity by determination of two physicians" provision, this provision is frequently criticized for being slow, expensive, and requiring provisions in the estate plan that waive medical information privacy protections afforded by the Health Insurance Portability and Accountability Act of 1996 (HIPAA) and California's Confidentiality of Medical Information Act (CMIA).

7. The controversy involving former Los Angeles Clippers owner Donald Sterling concerned a trustee removal pursuant to the trust instrument.

8. After Donald reneged on an agreement to sell the Clippers to ex-Microsoft CEO Steve Ballmer, his wife Shelly Sterling invoked a provision in the Sterling Family Trust to remove Donald Sterling as a trustee after two neurologists determined he was mentally incapacitated and no longer able to conduct his own legal and business affairs.

9. Shelly Sterling, as the sole remaining trustee, then completed the sale of the Clippers to Ballmer.

D. *Removal by Court* – A trustee may be removed by a settlor, co-trustee or beneficiary by petition filed pursuant to Probate Code §17200. Probate Code §15642(a).

1. 2006 legislation amending Probate Code section 15642 empowered the court to remove a trustee who is substantially unable to manage the trust's financial resources, who is otherwise substantially unable to execute properly the duties of the office, or who is substantially unable to resist fraud or undue influence. Stats. 2006, Ch. 84. The impetus of this legislation was that removal of a settlor-trustee was thought to be preferable to a conservatorship proceeding.

2. At present a trustee may be removed under Probate Code §15642 if

a) the trustee is substantially unable to manage the trust's financial resources or is otherwise substantially unable to properly execute the duties of office (as determined under Probate Code §§810–813), Probate Code §15642(b) (7); or

b) The trustee is substantially unable to resist fraud or undue influence. Probate Code §15642(b) (8).

3. Helpful to concerned beneficiaries and attorneys is the absence of the need for evidence of actual wrongdoing to remove a trustee. The court can remove a trustee in a preventative measure, not to inflict a penalty for past action, but to preserve trust assets. *Getty v Getty* (1988) 205 Cal.App.3d 134, 139. The court also can, in its discretion, appoint a "trustee ad litem" for the sole purpose of prosecuting or defending litigation, rather than removing the trustee. *Getty* at 141.

4. Lack of capacity and undue influence are of course distinct legal concepts and neither is a predicate of each other. Nevertheless, many people who suffer from lack of capacity are also susceptible to undue influence.

E. *Undue Influence*: A fiduciary's susceptibility to undue influence may become another indicator of the lack of ability to perform his or her fiduciary obligations. This outline will touch on basics of undue influence under the new statutory regime that was instituted this year.

1. Under AB 140 which took effect at the beginning of 2014, newly added Probate Code §86 states: "Undue influence" has the same meaning as defined in Section 15610.70 of the Welfare and Institutions Code. It is the intent of the Legislature that this section supplements the common law of undue influence without superseding or interfering with the operation of that law.

2. Welf & I C § 15610.70 (a) defines "Undue influence" as excessive persuasion that causes another person to act or refrain from acting by overcoming that person's free will and results in inequity. When determining whether a result was produced by undue influence, all of the following factors are considered:

> (1) The vulnerability of the victim. Evidence of vulnerability may include, but is not limited to, incapacity, illness, disability, injury, age, education, impaired cognitive function, emotional distress, isolation, or dependency, and whether the influencer knew or should have known of the alleged victim's vulnerability.
>
> (2) The influencer's apparent authority. Evidence of apparent authority may include, but is not limited to, status as a fiduciary, family member, care provider, health care professional, legal professional, spiritual adviser, expert, or other qualification.
>
> (3) The actions or tactics used by the influencer. Evidence of actions or tactics used may include, but is not limited to, all of the following:
>
> (4) Controlling necessaries of life, medication, the victim's interactions with others, access to information, or sleep.
>
> (5) Use of affection, intimidation, or coercion.
>
> (6) Initiation of changes in personal or property rights, use of haste or secrecy in effecting those changes, effecting changes at inappropriate times and places, and claims of expertise in effecting changes.
>
> (7) The equity of the result. Evidence of the equity of the result may include, but is not limited to, the economic consequences to the victim, any divergence from the victim's prior intent or course of conduct or dealing, the relationship of the value conveyed to the value of any services or consideration received, or the appropriateness of the change in light of the length and nature of the relationship.

b) Evidence of an inequitable result, without more, is not sufficient to prove undue influence. [Added by Stats. 2013, Ch. 668, Sec. 3. Effective January 1, 2014]

E. *Incapacity Issue of a Fading Settlor-Trustee of a Revocable Trust v. Incapacity Issues of a Settlor-Trustee of an Irrevocable Trust* – Removal of a trustee of a revocable trust vs. an irrevocable trust has not been discussed in case law yet. It stands to reason that the actions of a fading trustee of an irrevocable trust for which he or she may not be the primary beneficiary of (e.g. the standard surviving spouse as trustee of an irrevocable bypass trust) would be scrutinized to a greater degree than if she merely the trustee of her own revocable trust. And, while there is no precedent for removing the trustee of an irrevocable trust by amending it (e.g. amending the trust to remove the fading trustee for a competent trustee) the general process for amending irrevocable trusts might provide a viable solution.

1. Probate Code §15404 permits the settlor and all beneficiaries of a trust to compel the modification or termination of a trust upon unanimous consent. The inclusion of the settlor obviates the need to file a petition with the court.

2. Pursuant to petition the court can also modify or terminate an irrevocable trust (i) if all beneficiaries consent (Prob C §15403), (ii) if the settlor and some beneficiaries consent if the interests of the non-consenting beneficiaries are not substantially impaired (Prob C §15404(b)), (iii) if a trust has uneconomically low principal (Prob C §15408(a)), or (iv) for changed circumstances (Prob C §15409).

VIII. DUTY WHEN REPRESENTING THE TRUSTEE

A. The attorney is a fiduciary and agent of the client. Accordingly, the attorney is subject to the general laws that apply to agents (California Civil Code § 2296 et seq. [Law of Agency]),[7] as well as the ethical rules and fiduciary duties applicable to attorneys in their relationship with clients.

1. Duty of loyalty to the client. "The duty of loyalty forbids any act that would interfere with the dedication of a lawyer's entire energies to the client's interests." *Flatt v. Superior Court* (1994) 9 Cal.4th 275.

2. Duty of competence and diligence. *See* California's Rules of Professional Conduct ("CRPC") Rule 3-110 Failing to Act Competently. This duty of competence means an attorney must use the diligence, learning and skill, and abilities reasonably required to perform the legal service; Rule 3-400 Limiting Liability to Client; See also Model Rules of Professional Conduct ("MRPC") Rule 1.1, Rule 1.3; See *Matter of Riley*, (Review Dept. 1994), 3 Cal. State Bar Ct. Rptr. 91; *In the Matter of Nunez* (Review Dept.1992) 2 Cal. State Bar Ct.Rptr. 196, 200; *In the Matter of Bouyer* (Review Dept.1991) 1 Cal. State Bar Ct.Rptr. 404, 415.

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[7] All code sections cited in this outline are California statutes, unless otherwise noted specifically.

3. Duty to avoid conflicts of interest.

4. Duty of communication.[8]

5. Confidentiality.[9]

6. California does not follow Model Rules of Professional Conduct 1.6. A lawyer has an absolute duty to maintain client's confidences and preserve client's secrets. Bus & Prof C §6068(e) (1). The only statutory exception to this duty is to prevent a criminal act that the attorney reasonably believes is likely to result in death or substantial bodily harm. . Bus & Prof C §6068(e) (2).

B. A lawyer undertaking a matter should first be able to answer the following questions:

1. "Who is the client?" and

2. "What is the scope of the representation?"

C. The answers to these questions are essential because of two fundamental ethical rules governing lawyers:

1. A lawyer shall not represent parties having adverse interests;

2. A lawyer shall keep his client's confidences inviolate.

D. Family Members: Who is the Client? What is the Scope of the Representation?

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[8] B&P Code section 6068(m); Rules Prof. Conduct, (CRPR) rule 3-500; See also ABA Model Rules Prof. Conduct (MRPC) Rule 1.4; See *Matter of Nunez* (Review Dept.1992) 2 Cal. State Bar Ct. Rptr. 196, 200.

[9] MRPC 1.6: "(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b). (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary: (1) to prevent reasonably certain death or substantial bodily harm; (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services; (4) to secure legal advice about the lawyer's compliance with these Rules; (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; (6) to comply with other law or a court order; or (7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client. (c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client."

1. Family Groups often desire to use the same lawyer for estate planning and post mortem planning due to the clients' confidence in the particular lawyer or firm and the benefits of continuity of representation. The "family" lawyer is already familiar with the family relationships, philosophies, customs, history, assets, existing trusts, or other estate planning devices whenever a new family member becomes involved. Consequently, the family does not have to educate the lawyer about such matters. Furthermore, a centralized approach to a family's estate planning permits a more comprehensive approach to estate and business planning which can maximize the assets passing to the next generation and facilitate the responsible transfer of management and control.

2. In the case of representation of multiple family members, the most diligent and ethical lawyer can easily overlook the questions of "who is the client" and "what is the scope of the representation" because it is the nature of family representation to evolve over a significant period of time. Seldom do multiple family members or generations come to the lawyer at the outset asking for joint representation.

E. Even when the lawyer does remain sensitive to the applicability in the multiple family member context, he or she will find that the conflicts rules can pose practical problems of interpretation and compliance, especially in the area of "potential" adverse interests.

F. Other circumstances, however, are not so obvious. The duties owed to a trustee with diminishing capacity can often be at odds with the trustee's and beneficiaries' best interests.

1. When the counselor owes a duty of loyalty to the client, does he or she have a responsibility to persuade the trustee to resign if diminished capacity is present?

2. When the attorney owes a duty of confidentiality, how does the attorney inform third parties know about the fading trustee?

3. When the attorney owes a duty to keep the client reasonably informed, what must the attorney tell the fading trustee about the taken to remove him or her?

G. Does the attorney have a duty to trust beneficiaries?

1. In many states, courts hold that the lawyer for a fiduciary has a duty to non-client beneficiaries. The duty is described as derivative of the fiduciary's duties to the beneficiaries.

2. These courts often point out in support of this duty that the lawyer is being paid from assets of estate.

3. The ACTEC Commentaries to Rule 1.4 explain: If a lawyer is retained to represent a fiduciary generally with respect to the fiduciary estate, the lawyer

represents the fiduciary in a representative and not an individual capacity—the ultimate objective of which is to administer the fiduciary estate for the benefit of the beneficiaries. Giving recognition to the representative capacity in which the lawyer represents the fiduciary is appropriate because in such cases the lawyer is retained to perform services that benefit the fiduciary estate and, derivatively, the beneficiaries—not to perform services that benefit the fiduciary individually. The nature of the relationship is also suggested by the fact that the fiduciary and the lawyer for the fiduciary are both compensated from the fiduciary estate. Under some circumstances it is appropriate for the lawyer also to represent one or more of the beneficiaries of the fiduciary estate.

4. In California, however, the rule has been to the contrary.

a) California courts hold that when an attorney represents a fiduciary, such as an executor or trustee, the attorney's client is the fiduciary, in her capacity as a fiduciary. *Moeller v Superior Court* (1997) 16 C4th 1124, 1130, 69 CR2d 317; *Fletcher v Superior Court* (1996) 44 Cal.App.4th 773, 777, 52 CR2d 65.

b) Neither a trust nor an estate can be the client, because neither is a legal person, but rather the terminology is merely descriptive of a fiduciary relationship with property. Restatement (Second) of Trusts §2 (1959); *Moeller v Superior Court, supra,* 16 C4th 1124.

c) The beneficiary is not the client either, because the beneficiary and the fiduciary are distinct legal persons with distinct legal interests. *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 212; *Lasky, Haas, Cohler & Munter v Superior Court* (1985) 172 Cal.App.3d 264, 282. For this reason, the Supreme Court has held that beneficiaries are not entitled to discovery of communications between the fiduciary and her attorney. *Wells* at 212.

d) Thus, the principle that no duty exists between the fiduciary's attorney and the beneficiaries has been followed and discussed with approval in *Johnson v Superior Court* (1995) 38 Cal.App.4th 463, *Lasky, Haas, Cohler & Munter v Superior Court* (1985) 172 Cal.App.3d 264, 282 (court denied beneficiaries access to work product of attorney for trustee, explaining beneficiaries are not clients of trustee's attorney), *Saks v Daimon Raike & Co.* (1992) 7 Cal.App.4th 419 (rejecting negligence claim by beneficiary against trustee's attorney), and *Sullivan v Dorsa* (2005) 128 Cal.App.4th 947.

e) Since the fiduciary's attorney has no duty to the beneficiaries in California, it follows that the beneficiaries have no right to sue the fiduciary's attorney for malpractice. See *Borissoff v Taylor & Faust* (2004) 33 C4th 523, 15 CR3d 735.

f) Although many states consider that the attorney for the fiduciary has a duty to the beneficiaries that is derivative of the fiduciary's duty to beneficiaries, California imposes no such duty.

IX. FIDUCIARIES AND BENEFICIARIES

A. Consensual representation of a fiduciary and a beneficiary can arise in either one of the following contexts:

1. The lawyer represents a fiduciary in both fiduciary and individual capacities;

2. The lawyer represents both a fiduciary and a beneficiary in the same matter.

B. Individual Trustee

The legal qualifications in California for an individual trustee are minimal: anyone with the legal capacity to enter into contracts and to hold title to property may act as a trustee. A person is able to enter into contracts when that person has reached the age of majority, which is 18 in California. Fam. Code §§ 6500, 6701(b). Residents and nonresidents of California, including nonresident aliens of the U.S., can hold title to real or personal property in California. CC §671.

C. Single Trustee or Cotrustee

1. Generally, appointment of cotrustees makes trust administration more cumbersome because all cotrustees have a duty to participate in the management and administration of the trust. Prob. C. §15620 provides that "unless otherwise provided in the trust instrument, a power vested in two or more trustees may only be exercised by their unanimous action."

2. Cotrustees may be beneficial where such unanimity is desired by the settlor for trust administration or where the appointment of such cotrustees may prevent family conflict.

3. Other options include (1) the trust instrument clearly delineating different powers to different cotrustees and (2) the appointment of special trustees for certain property or powers.

D. Representing a Fiduciary Who is Also a Beneficiary

1. A beneficiary of a trust or estate may be named to act as the fiduciary. A lawyer may represent such person in both capacities.

2. Nevertheless, the lawyer should be alert to the potential conflicts that the client may have as a result of those dual roles. The lawyer should stress to the client that the fiduciary duty to act impartially and not to act in a manner that gives

preference to his or her own beneficial interest over the interests of the other beneficiaries.

3. For example, if the fiduciary-beneficiary proposes a non-pro-rata distribution of real property, the client may have conflict between the duty of impartiality as a fiduciary and his or her own self-interest in receiving certain property. The lawyer must delineate the potential conflict to the client and help the client resolve this conflict by obtaining the consent of the other beneficiaries, by obtaining court approval or, if necessary, by resigning as fiduciary.

4. The client's divided loyalties are not imputed to the lawyer because the lawyer's client is the individual.

5. Even when the fiduciary is not a beneficiary, the lawyer for the fiduciary may also represent the fiduciary individually. For example, unless the fiduciary has waived compensation for his or her services or intends to request only the fee prescribed by statute by the trust or will, the fiduciary may be acting in his or her own interest when seeking fiduciary compensation.

6. Similarly, the fiduciary may be judicially determined to be acting individually in defending a challenge to an accounting, or defending a claim of breach of his fiduciary duty.

7. The fiduciary will be acting as an individual if the fiduciary presents a claim as a creditor of the trust or estate. If the fiduciary does present such a claim, the fiduciary is in an adverse relationship with the trust or estate. If the creditor claim arises, at the very least the fiduciary will not be able to represent the trust or estate with regard to the creditor claim, and may be removed or suspended for the conflict.

8. If the fiduciary intends to pursue a claim as a creditor, the attorney for the fiduciary also has a conflict of interest and must advise the fiduciary to seek separate counsel to represent the individual as creditor.

9. A lawyer should be careful to distinguish between services to a client as fiduciary and to the client individually, should charge for them separately, and should advise the client that the services to the client in his or her individual capacity must be paid for personally and not from the trust or estate.

E. Limitations on the Relationship

1. A lawyer and client may by agreement limit the scope of the lawyer's representation. They may agree that the lawyer will advise the client only with regard to the administration of the trust or estate and not with respect to any matters, such as the fiduciary's compensation, when the fiduciary's interest may be adverse to the beneficiaries.

2. No ethical duty requires that a lawyer accept or refrain from representing a client in all capacities; nevertheless practical reasons may exist why the lawyer and client desire to limit the scope of the representation.

3. The lawyer or client may anticipate that administration of the trust or estate will be difficult because of divergent interests between the fiduciary and interested parties.

4. These divergent interests may be due to a family relationship, for example, a stepparent and stepchild; or because of particular assets such as a family home that both the fiduciary and another beneficiary wish to receive as part of their share of the estate property.

5. When potentially conflicting circumstances are present, the lawyer and client may agree that the lawyer will represent the client only as the fiduciary in order (a) to avoid concern that the lawyer's duty of loyalty to the client in his or her individual capacity will interfere with the lawyer's representation of the client as fiduciary; (b) to preserve the lawyer's credibility; and (c) to preserve the lawyer's ability to communicate with the beneficiaries in connection with administration matters.

6. Under such representation, the lawyer and client may agree that all information, including otherwise confidential communications between the lawyer and client and information discovered by the lawyer that may be adverse to the client's personal interests, may be disclosed to the beneficiaries by the lawyer.

7. For similar reasons, the fiduciary's lawyer may suggest that the fiduciary obtain separate counsel to represent her individually. For example, a fiduciary/beneficiary involved in estate litigation as beneficiary may choose to have separate counsel in the litigation to eliminate any question that the confidential communications with his or her litigation lawyer are privileged. Likewise, having separate counsel in each capacity could discourage claims by other beneficiaries that the fiduciary's lawyer's fees are partly personal, and, therefore, should not be paid from the estate.

F. Representing a fiduciary and beneficiary who are not the same person in the same matter

1. A lawyer may represent a fiduciary and a beneficiary in the same matter, but only with the informed written consent of both clients. The lawyer representing the fiduciary and fewer than all the beneficiaries will have at least the appearance of bias in favor of the beneficiaries who are his or her clients.

2. A potential conflict of interest exists because issues may arise regarding the fiduciary's fees, settlement of the fiduciary's account, alleged breaches of fiduciary duties, and the fiduciary's treatment of other beneficiaries.

3. In order to be certain that the clients' consents and waivers are informed, the lawyer should describe these potential conflicts in a writing, preferably the engagement letter.

4. The writing should also discuss (a) whether the lawyer may disclose to one client confidential information obtained from the other client, and (b) whether the lawyer may continue to represent one client if an actual conflict arises.

5. This potential conflict may affect the fiduciary's duty of impartiality. To protect the fiduciary from accusations of favoritism, the fiduciary should obtain the informed written consent of all beneficiaries, or probate court approval, for any action by the fiduciary that would affect the individual beneficiaries differently.

6. The lawyer's potential conflict of interest should also be disclosed to the other beneficiaries or to the court, as the case may be, to avoid accusations of extrinsic fraud, and, therefore, questions about the finality of any settled matter.

7. In general, dual representation, especially when multiple beneficiaries are represented, may result in conflict of interest issues between the fiduciary and a beneficiary and a beneficiary that can be avoided by representing the fiduciary only.

G. Representation imposed by circumstances

1. The general rule is that the lawyer for the fiduciary represents only the fiduciary and does not represent the "estate" or the "trust" or the beneficiaries.

2. Nevertheless, circumstances exist under which a "duty" may be imposed on the lawyer and the ethical considerations governing the lawyer-client relationship may apply.

3. The general rule is that a lawyer owes a duty to his or her client, but not to third parties. Although the lawyer performs services that may benefit estate or trust beneficiaries, the lawyer has no contractual privity with the beneficiaries, and the beneficiaries are only "incidental beneficiaries" to whom no duty arises.

4. An action for malpractice by the estate beneficiaries against the lawyer for the administrator will not lie because the lawyer's representation of the administrator was "not entered into for the principal purpose of providing benefit to the legatee," and the fact that such beneficiaries may be benefited or damaged by the lawyer's performance "does not give rise to a duty by the attorney to such third parties." *Goldberg v. Frye*, 217 Cal. App 3d 1258, 1268 (Ct. App. 3d 1258, 1268 (Ct. App. 1990).

H. Lawyer's liability to third parties

1. Despite a lack of contractual or privity relationship with a third party, the lawyer may be found to owe a duty in specific cases upon the balancing of various

factors, including the extent to which the transaction was intended to benefit the third party and the closeness of the connection between the lawyer's conduct and the alleged injury suffered.

2. The cases that have considered and found such a duty have arisen not in the ethics arena, but in the civil liability arena. Nonetheless, the facts and conduct in those cases are illustrative of problem areas in the ethics arena.

3. If a duty is found for civil liability and the lawyer-client relationship is the foundation for that duty, the lawyer may be subject to scrutiny for breach of an ethical duty.

4. Among the circumstances under which a civil liability duty to the beneficiaries can be imposed are the following:

a) The lawyer may be held liable to the beneficiaries if the lawyer actively participates in a breach of trust;

b) The lawyer has a responsibility to disclose to the beneficiaries any potential conflict of interest that the lawyer may have which affects the beneficiaries' interests;

c) The lawyer may assume responsibilities to the beneficiaries that the lawyer would otherwise not have by telling, or implying, to the beneficiaries that he or she represents the "estate" or "trust" or is otherwise protecting the interests of the beneficiaries.

5. To avoid the problem of "inadvertent" representation imposed by circumstances, some lawyers for fiduciaries notify all the beneficiaries in writing that they represent only the fiduciaries and that the beneficiaries may retain their own lawyers.

6. This approach may be prudent if the beneficiaries have reason to believe that the fiduciary's lawyer is representing them because a lawyer has a duty to communicate to persons who reasonably believe they are clients, at least to the extent of advising them that they are not clients.

I. Organization as fiduciary client

1. While representing a corporate fiduciary of a trust or probate estate (Client #1), the lawyer should avoid representing a person who has an interest adverse to the corporate fiduciary, even if the representation is in connection with an entirely different matter.

2. Some corporate fiduciaries have taken the position that once a lawyer has represented them, the lawyer may never represent another client in a matter adverse to the corporate fiduciary. This position is of questionable propriety.

Nevertheless, a prospective client is unlikely to be willing to undergo the litigation necessary to resolve the issue. This reluctance will prevent the lawyer from undertaking that representation.

3. A lawyer who is asked to represent a corporate fiduciary of a trust or probate estate should consider discussing with the fiduciary at the outset the extent to which the representation might preclude the lawyer from representing an adverse party in an unrelated future matter.

J. The ACTEC Commentaries on the Model Rules Of Professional Conduct: Commentary on MRPC 1.7 (4th ed, 2006), opine that in the absence of a contrary agreement, a lawyer who represents a corporate fiduciary in a representative capacity only should not be precluded from representing an adverse party in connection with a wholly unrelated matter, such as a real estate transaction or another estate or trust administration.

X. ATTORNEY-CLIENT-PRIVILEGE ISSUES FOLLOWING REMOVAL

A. The "fading trustee" has been removed either by his/her own volition, by the terms of the trust, or via removal in court. A new trustee has stepped to the fore. Where does privilege lie?

B. In general, a party's confidential attorney-client communications are privileged from disclosure. Evidence Code §§952, 954. However, there is an important exception for trustees. After a trustee's resignation or removal, the successor trustee generally becomes the holder of the attorney-client privilege with respect to "confidential communications that occurred when the predecessor, in its fiduciary capacity, sought the attorney's advice for guidance in administering the trust." *Moeller v Superior Court* (1997) 16 C4th 1124, 1134.

C. This important exception can help provide continuity from the tenure of the "fading trustee" to the new competent trustee.

D. The successor trustee is entitled to discover the predecessor's attorney-client communications on matters of trust administration and, seemingly, free to waive the privilege and permit disclosure to others, including beneficiaries.

E. Like any good legal exception, this exception has an exception. Accordingly, the successor trustee cannot discover all the predecessor's attorney-client communications. The previous trustee retains the privilege regarding advice sought for its own protection. *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 209.

F. *Moeller* somewhat unrealistically requires the trustee to "scrupulously and painstakingly" distinguish its interests from those of the beneficiaries. 16 C4th at 1135

G. In contrast, trust beneficiaries generally do not have a right to obtain disclosure of trustee attorney-client communications, whether about trust administration or potential trustee liability. *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201.

H. Removal coupled with voluntary waiver of privilege by the successor trustee is thus the only way that beneficiaries can "compel" a trustee's confidential attorney-client communications

XI. CONCLUSION

A. The problem of the "fading trustee" and the "fading settlor-trustee" will expand as life expectancies increase without concomitant advances in the treatment of cognitive impairment. These problems are compounded by the well-intentioned but restrictive one-way street of duties owed: The attorney owes the trustee a duty, the trustee owes a duty to the person with the power to revoke; no one owes a duty to the beneficiaries until the power-holder has lost the power to revoke. The unfortunate result has been uncertainty and confusion, preventing meaningful understanding of the attorney's role and responsibility. The legal, psychological, and interpersonal consequences of dealing with a trustee of uncertain capacity are the new frontier confronting lawyers in trust administration.

B. The law's bias will be to require the person or persons seeking removal of a trustee to submit evidence that the deficits bear directly on and adversely influence the fiduciary's ability to administer the trust. When the inevitable case arrives at the Court of Appeal, the author hopes that the Court will apply DPCDA's "sliding scale" to impose a requirement of capacity on fiduciaries greater than that imposed on persons entering into contract. The law needs to develop a fiduciary capacity standard to ease the burden of trustee removal.

C. A lawyer whose client-trustee is exhibiting symptoms of diminishing capacity will find himself or herself in an awkward ethical quandary. The lawyer's ability to communicate his or her concern about the client is severely circumscribed by the California rules of professional responsibility. The best defense for these lawyers is to encourage the active participation of close friends and family members with the trustee. Having concerned but nonprofessional individuals paying attention to the mental condition of the fading trustee may also ameliorate these ethical limitations.

D. Anticipating the possibility of a fading trustee with flexible and responsive trust provisions appears to be the preferred solution. A variety of methods are available, some of which have been highlighted in this article. The author is confident that as practitioners far more imaginative then he consider this problem, even more creative solutions will be devised.

E. Resolving these issues is complicated by the lack of applicable authority providing guidance on available remedies for dealing with the fading trustee. Until such guidance is offered, practitioners would do well to seek to anticipate these problems by drafting for the eventuality.

<u>Exhibit A</u>

REMOVAL OF INDIVIDUAL DUE TO INCAPACITY

Any individual who is deemed incapacitated, as defined in Paragraph 10.24., shall cease to serve as a Trustee of all trusts administered under this document. Each individual who agrees to serve as a Trustee of any trust administered under this document (A) shall cooperate in any examination reasonably appropriate to carry out the provisions of this Paragraph 7.5.c., (B) waives the doctor-patient and/or psychiatrist-patient privilege with respect to the results of such examination, and (C) shall allow a Co-Trustee or the Current Beneficiaries of the trust to review the individual's individually identifiable health information or other medical records, waiving any privacy rights governed by the Health Insurance Portability and Accountability Act of 1996, 42 U.S.C. §1320d (HIPAA), and the regulations thereunder, including 45 C.F.R. §§160-164, to the extent required to implement this Paragraph 7.5.c. An individual's obligation to comply with the provisions of this Paragraph 7.5.c. is specifically enforceable.

REMOVAL OF TRUSTEE FOR CAUSE

A. MAJORITY BENEFICIARIES MAY REMOVE TRUSTEE FOR CAUSE

The Majority Beneficiaries of any trust may remove any Trustee thereof for reasonable cause by delivering written notice of the removal which specifies the reasonable cause for the removal to all persons then serving as Trustee, to the Replacement Trustee and to all other Current Beneficiaries of the trust.

B. CAUSES FOR REMOVAL

As used in this Paragraph 7.5.d., the term "reasonable cause" includes (A) the incapacity of the Trustee as provided in Paragraph 7.5.c., (B) the willful or negligent mismanagement of the trust assets by the Trustee, (C) the abuse or abandonment of, or inattention to, the trust by the Trustee, (D) a federal or state charge against the Trustee involving the commission of a felony or serious misdemeanor, (D) an act of stealing, dishonesty, fraud, embezzlement, moral turpitude or moral degeneration by the Trustee, (F) Substance Abuse by the Trustee, (G) the Trustee's poor physical, mental or emotional health which causes the Trustee to be unable to devote sufficient time to administer the trust, (H) the Trustee's failure to comply with a written agreement regarding compensation or any other legally enforceable written agreement affecting the trust's operation, (I) a demand for at least five (5) years of experience in administering trusts to handle the account, (K) unreasonably high turnover of account officers assigned to the trust (unless requested by the Majority Beneficiaries), (L) unreasonably poor investment performance, (M) the removal of all Current Beneficiaries from the State in which the corporate Trustee is licensed to conduct business as a corporate Trustee, (N) the relocation of the Trustee away from the location where the trust operates so as to interfere with the administration of the trust, (O) unreasonable lack of communication between the Trustee and the Current Beneficiaries, (P) unreasonably inaccurate or unclear transaction statements or statements of account, (Q) unreasonable conflicts between the Trustee and the Current Beneficiaries caused by the Trustee, (R) merger, acquisition or a

deteriorating financial condition of a corporate Trustee, or (S) any other reason for which a court of competent jurisdiction would remove a Trustee.

INCAPACITY

"Incapacity" and derivations thereof mean incapable of managing an individual's affairs under the criteria set forth in California Probate Code §810 et seq. An individual shall be deemed to be incapacitated if any of the following conditions exist: (a) the individual's regular attending physician (provided such physician is not related by blood or marriage to any Trustee or beneficiary) examines the individual and certifies in writing that the individual is incapacitated, (b) two licensed physicians who, as a regular part of their practice are called upon to determine the capacity of others, and neither of whom is related by blood or marriage to any Trustee or beneficiary, examine the individual and certify in writing that the individual is incapacitated or (c) an order of the court having jurisdiction over the trust as to which the individual is service as a Trustee or as to which the individual is a beneficiary, as the case may be, finds that the individual is incapacitated. The expenses of any examination or court proceeding to determine if any individual is incapacitated shall be paid (i) if the individual is a Settlor, from all trusts established under this document revocable by him or her, and (ii) if the individual is a Trustee but not a Current Beneficiary other than a Settlor, from all trusts established under this document with respect to which he or she is a Current Beneficiary and (iii) if the individual is a Trustee but not a Current Beneficiary under this document, from all trusts administered under this document as to which the individual is serving as a Trustee, in each case in proportion to the relative values of the trusts from which payment is to be made.

Exhibit B

DEFINITION OF INCAPACITY

As used in this instrument, "incapacity" or "incapacitated" means a person operating under a legal disability such as a duly established conservatorship, or a person who is determined to be incapacitated under the further provisions of this section:

a) A person may be determined to be "incapacitated" or suffer from "incapacity" if either of the following circumstances applies:

    1) The person is unable to provide properly for that person's own needs for physical health, food, clothing, or shelter; or

    2) The person is unable to manage substantially that person's own financial resources, or resist fraud or undue influence.

b) The certification of incapacity may be made by a committee composed of:

    1) One Physician (licensed to practice under the laws of the state where the settlors are domiciled at the time of the certification);

    2) A settlor other than a settlor whose capacity is at issue, if willing and able to make a timely determination; and

    3) Any one of the settlors' children who is not otherwise serving on the committee acting unanimously, that the person is incapacitated under the standard set forth in this section. The certification must be made by each committee member in a written declaration under penalty of perjury.

c) In case of temporary incapacity of a sole trustee, the successor trustee designated under this instrument will serve during the period of temporary incapacity as though he or she were the only trustee. In case of temporary incapacity of a cotrustee, the other cotrustee will make any and all decisions during the period of temporary incapacity as though that cotrustee were the only trustee.

d) Any trustee deemed to be temporarily incapacitated is permanently incapacitated 90 days after the determination of temporary incapacity unless a determination of capacity is made within that 90-day period. If a determination of capacity is made, the trustee may resume serving as trustee. If there is a subsequent determination of incapacity, the trustee has another 90-day period to obtain a determination of capacity.

e) Any successor trustee or cotrustee serving in place of a temporarily incapacitated trustee is not relieved of liability until that trustee's account has been settled or an account has been waived by all current beneficiaries of the trust.

f) In any trustee or any beneficiary whose capacity is in question disputes the determination of incapacity under any of the standards listed above, such person may petition the court for a finding regarding that person's capacity. The court's finding shall be conclusive. If the court determines that the trustee or other person whose capacity is in question has capacity, the trust property bears all expenses associated with the examination or court proceeding. If the court sustains the determination of incapacity, the individual challenging the determination of incapacity bears all expenses of the examination or court proceeding.

g) Each individual trustee agrees to cooperate in any examination reasonably necessary for the purpose of determining capacity, agrees to waive the doctor-patient privilege in respect to the results of such examination, and agrees to provide written authorization in compliance with the privacy regulations under the Health Insurance Portability and Accountability Act of 1996 (42 U.S.C. Section 1320d) and the provisions of California Civil Code Section 56.10 for the disclosure and use of that trustee's health information and medical records to the extent that such disclosure and use are necessary to make a determination of the trustee's capacity.

Exhibit C

DEFINITION OF INCAPACITY

1. For purposes of this instrument, a person is deemed "incapacitated" or deemed to suffer from "incapacity" if any of the following circumstances apply:

    a. The person is unable to provide properly for that person's own needs for physical health, food, clothing, or shelter; to manage substantially that person's own financial resources; or to resist fraud or undue influence.

    b. Either a medical doctor, board-certified neuropsychologist, or a board-certified psychiatrist, not related by blood or marriage to any trustee or beneficiary, examines such person and declares under penalty of perjury that such person is either temporarily or permanently incapacitated, according to generally accepted medical definitions.

    c. The person is operating under a legal disability, such as a duly established conservatorship.

    d. The court makes a finding that the person is either temporarily or permanently incapacitated under the criteria set forth in Prob. Code Section 810 et seq.

    e. If the person whose capacity is in question is a trustee or cotrustee, the judgment of a majority of the following persons regarding the capacity of the trustee or cotrustee is another method by which that person may be deemed "incapacitated" or deemed to suffer from "incapacity" for the purposes of this instrument: the successor trustee and the current beneficiaries of the trust.

2. In case of temporary incapacity of a sole trustee, the successor trustee designated under this instrument shall serve during the period of temporary incapacity as though he or she were the only trustee. In case of temporary incapacity of a cotrustee, the other cotrustee shall make any and all decisions during the period of temporary incapacity as though that cotrustee were the only trustee.

3. Any trustee deemed to be temporarily incapacitated shall be deemed to be permanently incapacitated ninety (90) days after the determination of temporary incapacity unless a determination of capacity is made within that 90-day period. If a determination of capacity is made, the trustee may resume serving as trustee. If there is a subsequent determination of incapacity, the trustee has another 90-day period to obtain a determination of capacity.

4. Any successor trustee or cotrustee serving in place of a temporarily incapacitated trustee shall not be relieved of liability until that trustee's account has been settled or an account has been waived by a majority of all current beneficiaries of the trust.

5. If any trustee or any beneficiary whose capacity is in question disputes the determination of incapacity under any of the standards listed above, such person may petition the court for a finding regarding that person's capacity. The court's finding shall be conclusive. If the court determines that the trustee or other person whose capacity is in question has capacity, the trust property shall bear all expenses associated with the examination or court proceeding. If the court sustains the determination of incapacity, the individual challenging the determination of incapacity shall bear all expenses of the examination or court proceeding.

6. Each individual trustee agrees to cooperate in any examination reasonably necessary for the purpose of determining capacity, agrees to waive the doctor-patient privilege in respect to the results of such examination, and agrees to provide written authorization in compliance with the privacy regulations under the Health Insurance Portability and Accountability Act of 1996 (42 U.S.C. Section 1320d) and the provisions of California Civil Code Section 56.10 for the disclosure and use of that trustee's health information and medical records to the extent that such disclosure and use are necessary to make a determination of the trustee's capacity. Refusal to submit to the examination, to provide the waiver, or to provide the written authorization when requested by the successor trustee and the current beneficiaries of the trust shall be deemed a resignation by that trustee.

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[i] *In re Marriage of Greenway, supra,* 217 Cal.App.4th 628.

[ii] *Anderson v. Hunt*, *supra,* 196 Cal.App.4th 722.

[iii] *Lintz v. Lintz, supra,* 222 Cal.App.4th 1346.

[iv] Prob. Code, section 16000.

[v] *Meinhard v. Salmon, supra,* 249 N.Y. 458 at p. 464.

ESTATE PLANNING TO AVOID LITIGATION: WAYS TO TURN WHAT MAY SEEM INEVITABLE TO AVOIDABLE

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ESTATE PLANNING TO AVOID LITIGATION: WAYS TO TURN WHAT MAY SEEM INEVITABLE TO AVOIDABLE

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I. INTRODUCTION

Unfortunately, we are faced with the reality that probate and trust litigation is increasing. For estate and trust litigators, this reality is exciting. For estate planners, this reality is daunting. A major goal in any estate plan is to see that the decedent's wishes are carried out to the fullest extent possible. Often times, probate and trust litigation prevent the settlor's goal from being accomplished. The goal for this set of materials is to provide strategies to the estate planning attorney to prepare and implement an estate plan that will allow the decedent's wishes to be carried out and to prevent the probate and trust litigators from becoming the unintended beneficiaries of the estate plan.

The thoughtful estate planner can take many steps during the planning process to reduce the chances of litigation arising after the key witness, the client, has left the scene. Generally organized around the most common causes of actions that are litigated in estates and trusts matters, this paper will discuss various prophylactic steps that can be taken: i) to reduce the chances a disgruntled beneficiary will attack the deceased client's estate plan or ii), in the event of an attack, to heighten the chances that the estate plan will be successfully defended. Conversely, the estate planner's unexplained failure to take one or more of the following suggested steps may end up as an item on a checklist for the trial lawyer contemplating a post-death challenge to the client's testamentary instruments.

II. WILL AND TRUST CONTESTS GENERALLY

A. Lack of Testamentary Capacity

1. Videotaping. Should the execution of testamentary instruments (wills and trusts) be videotaped? There are pros and cons to videotaping.

   a. The videotape may expose and document errors in the execution process that otherwise might go unnoticed or be forgotten by the time of the client's death. For example, a witness may step out of the room while the documents are being signed, so that the client and the witnesses did not each execute the instrument in the

presence of all the others. Similarly, the taping may record something that was innocuous, but that, when taken out of context, creates litigation exposure -- for example, if the client makes a statement intended to be humorous, such as that the document was too long to read or that it is too complex for the client to understand.

b. If videotaping is not a part of the attorney's customary and ordinary practice, it may raise more questions than it answers. (For example, "What conditions made you decide to videotape the execution of this particular client's will"?; "Why for the first time in your 55 years of practice as an estate planning specialist did you decide to videotape this particular execution ceremony?") Furthermore, the supervising attorney may not have the experience necessary to "direct" the production of a videotape that will be convincing when viewed over television monitors in a courtroom.

c. Will the videotape be admissible into evidence? What authentication procedures should be followed, and how should the tape be secured? In California, the videotape may be admitted into evidence as a statement of intent and it may be authenticated by the videographer.

d. Note the expense considerations: A professional video operator is preferable if the expense is warranted.

2. Witnesses. How should witnesses be selected for the execution ceremony?

a. In general, witnesses should be persons who are likely to be available at trial, who will be credible, and who will be likely to remember the details of the document execution once their memory is refreshed.

b. Office employees such as secretaries may not remember the client, or they may not be readily available as witnesses at the time of trial. If the employee's employment is later terminated involuntarily, the witness may not be cooperative. Nevertheless, secretaries are readily accessible and, properly trained, are familiar with standard execution requirements.

c. Although their involvement may be inconvenient and disruptive to their own practice, other attorneys (such as younger associates) in the office may be more likely to be available and may provide more credible testimony on questions of capacity.

d. Long-time friends of the client may be subject to competing loyalties to the litigants. If the client and the client's friends are

elderly, there may be a greater than normal mortality risk that the witnesses will not be available at the time of trial.

3. Witness Preparation. Should the supervising attorney prepare the witnesses before the execution ceremony, and if so, how?

   a. The supervising attorney may choose to discuss the client's condition and capacity issues with the witnesses before the execution ceremony. Doing so, however, may simply cause the witnesses to focus on the client's mental status during the meeting more than they should, and could raise doubts in the minds of the witnesses that might surface on cross examination during the litigation.

   b. If not part of the supervising attorney's customary operating practices, the fact that the attorney went out of his or her way to prepare witnesses in a particular situation could create credibility issues.

4. The Execution Ceremony. Care should be exercised in handling the execution ceremony.

   a. If the client's condition fluctuates, the execution should occur on a date and at a time when the client's condition is most favorable. This may require advance consultation with the client's doctors and other health care providers. If the client seems to be in questionable mental or physical condition on the date chosen, the execution ceremony should be rescheduled unless it is likely that the client's condition will deteriorate further.

   b. When the attorney meets with the client, consideration should be given to having the witnesses join the meeting before the actual signing of the documents. This will give the witnesses a greater chance to observe the client's participation in discussions that will bolster their observations about the client's capacity, and also increase the chances that the witnesses will be able to give meaningful testimony about the client's capacity. The discussion should cover topics that establish the client's awareness of current events and his or her circumstances (such as current political or news events, discussion of the client's family, etc.). Care should be taken to avoid the time pressures and interruptions that are typical of the usual will or trust signing in an attorney's office. The attorney should meet with the client alone at first, however, to make a preliminary evaluation of the client's condition and to review the estate planning documents in confidence with the client. (The presence of a second lawyer or a paralegal assistant may also be warranted under the circumstances. Such a person's presence

may be used to corroborate the principal lawyer's later testimony about what transpired.)

c. "Custom and usage" generally: There is much to be said for scripting with care an execution ceremony that the lawyer regularly and customarily uses in her practice. Thus, for example, if the lawyer **always** reads the attestation clause to the witnesses, asks the witnesses if the statements about the client's capacity, lack of undue influence, duress, etc. are true, and can later testify, without necessarily remembering the specific execution ceremony, "I don't remember all the exact facts of this execution ceremony seven years ago, but I always read the attestation clause in full to the witnesses and ask them to agree that the statements made therein are true and correct," this testimony is likely to impress the trier of fact. If called much later to testify, the forgetful witness can then quite truthfully say, *e.g.*, "Well I don't remember the exact circumstances of the execution, but I certainly wouldn't have signed my name to any statement 'under penalty of perjury' if I didn't believe those facts." (*See* Exhibit A, page 18, Will Attestation Clause for Use in California.)

5. Medical Examination. A medical or mental capacity examination of the client, conducted on or near the same date as the document execution, can help establish the client's condition. Evaluation of the client by his or her attending physician on the day of the document execution may be advisable under some circumstances. In cases involving clients whose mental capacity is marginal, consider an examination not only by the client's regular physician but also by a qualified geriatric psychiatrist or psychologist. Absent such an examination, the attorney herself, if fully educated and familiar with capacity exams, may, at least at a basic level, assuage her concerns about a client's mental capacity by administering a short, self-contained test such as the Folstein Mini-Mental Status Exam. For a detailed questionnaire, see, e.g., "Legal Capacity Questionnaire," *Mental Capacity: Legal and Medical Aspects of Assessment and Treatment*, Walsh, Brown, Kaye & Griegsby (2d Ed. Shepard's 1994). *See also*, "Contest Planning for the Client with Marginal Capacity: A Checklist of Strategical and Technical Considerations and Options" (Wills & Trusts Subcommittee of the Fiduciary Litigation Committee, ACTEC 1997).

6. Medical Records. If the client is hospitalized, the client's medical records should be preserved. Interviews or witness statements should be obtained from persons in regular contact with the client (doctors, nurses, attendants).

7. Timing of Execution. If possible, coordinate the timing of the execution of estate planning documents with highly visible events which will present

the client in a favorable light and supply a large number of potential favorable witnesses about the client's capacity -- e.g., an honors award, a large birthday celebration, etc.

8. Special Language re Capacity. Rather than traditional language in a will referring to the client "being of sound mind and body" (or no such language at all), perhaps a statement in the testamentary instrument acknowledging that the client has diminished capacity or health issues might have some value.

> Example: "Because I have been diagnosed as having senile dementia, probable Alzheimer's, I recognize that some persons who will be disappointed with the provisions of my testamentary plan may question my capacity and may consider challenging the validity of this instrument. However, my illness has not progressed to the point that my judgment and thinking about my assets, my loved ones and my estate plan have been materially impaired. I have given very careful consideration to my testamentary affairs, and I affirm that the dispositions made in this instrument reflect my decisions, which I have carefully and unequivocally reached after deliberation and after seeking the advice and counsel of my attorney J. Doe, who has prepared this instrument at my direction. Both my counsel and I are initialing here, ______ (Testator), _______ (Attorney), to reflect my attention to and understanding of this paragraph."

9. Attorney's Memorandum. The attorney may want to consider preparing a memorandum summarizing the circumstances leading up to and including the execution of the testamentary instrument, and setting forth the attorney's own observations of the client. The attorney may also want to have each of the witnesses prepare a memorandum summarizing his or her observations about the client when the document was executed.

10. Client With Diminished Capacity. If the attorney believes that the client's testamentary capacity is diminished and that any documents prepared by the attorney almost certainly will be challenged in litigation, does the attorney have a duty to prepare estate planning documents when instructed to do so by the client? Consider for example, the *ACTEC Commentaries on the Model Rules of Professional Conduct* (4th Ed. 2006) (hereinafter "ACTEC Commentaries"), specifically the Commentary on MRPC 1.14:

> "*Testamentary Capacity*. If the testamentary capacity of a client is uncertain, the lawyer should exercise particular caution in assisting the client to modify his or her estate plan. The lawyer generally should not prepare a will, trust

> agreement or other dispositive instrument for a client who the lawyer reasonably believes lacks the requisite capacity. On the other hand, because of the importance of testamentary freedom, the lawyer may properly assist clients whose testamentary capacity appears to be borderline. In any such case, the lawyer should take steps to preserve evidence regarding the client's testamentary capacity. In cases involving clients of doubtful testamentary capacity, the lawyer should consider, if available, procedures for obtaining court supervision of the proposed estate plan, including substituted judgment proceedings." *ACTEC Commentaries* at 132.

Compare *Florida Bar v. Betts*, 530 So.2d 928 (Fla. 1988), with *Vignes v. Weiskopf*, 42 So.2d 84 (Fla. 1949).

In the *Betts* case an attorney was publicly reprimanded for preparing two codicils to the will of his client when the client was in a rapidly deteriorating physical and mental state. In the first codicil the testator removed his daughter and son-in-law as beneficiaries. After speaking with his client several times in an effort to persuade the testator to reinstate his daughter as a beneficiary, the lawyer prepared a second codicil reflecting this change. However, when the codicil was presented to the testator for execution, he was in a comatose state. The lawyer did not read the second codicil to the testator nor did the testator make any verbal response when the lawyer gave the codicil to him. The lawyer had the codicil executed by an "X" that the lawyer marked on the document with a pen that he had placed and guided in the testator's hand. The court observed:

> "Improperly coercing an apparently incompetent client into executing a codicil raises serious questions both of ethical and legal impropriety, and could potentially result in damage to the client or third-parties. It is undisputed that [Lawyer] did not benefit by his action and was merely acting out of his belief that the client's family should not be disinherited. Nevertheless, a lawyer's responsibility is to execute his client's wishes, not his own." 530 So. 2d at 929.

In *Vignes v. Weiskopf, supra*, the Supreme Court of Florida held that it was not improper for a lawyer to prepare and supervise the execution of a codicil for a client who was "incurably ill and was in such pain that a great deal of medication to relieve him of his suffering was being administered, such as phenobarbital, novatrine, demerol, cobra venom, and so forth." The court stated that:

> "We are convinced that the lawyer should have complied as nearly as he could with the testator's request, should have exposed the true situation to the court, which he did, and should have then left the matter to that tribunal to decide whether in view of all facts surrounding the execution of the codicil it should be admitted to probate.
>
> "Had the attorney arrogated to himself the power and responsibility of determining the capacity of the testator, decided he was incapacitated, and departed, he would indeed have been subjected to severe criticism when, after the testator's death, it was discovered that because of his presumptuousness the last-minute effort of a dying man to change his will had been thwarted." 42 So. 2d at 86.

In California, the attorney does not have an obligation to determine capacity and has no liability for proceeding if he/she thinks the client has capacity. See, *Moore v. Anderson Zeigler Disharoon Gallagher & Gray*, 109 Cal. App. 4th 1287 (2003). The court believed that putting such an onus on a lawyer would stymie the client's free will to create a plan because lawyers, who are not trained doctors to make such determinations, would be reluctant to prepare plans.

B. Undue Influence

1. Contacts with Beneficiary: What should the estate planning attorney do if a potential will beneficiary has initiated the client's first contact about estate planning with the attorney?

   a. Communication with the potential beneficiary should be limited to providing information that is relevant to retention of the attorney.

   b. If the attorney believes that the potential beneficiary is attempting to influence the direction of the planning or is seeking more than routine information, the attorney should advise the potential beneficiary about the risks of undue influence. Failure to do so conceivably could subject the attorney to negligence claims if the attorney proceeds with estate planning that is later invalidated because of undue influence. In situations like this, it may make sense to provide a non-representation letter to the beneficiary, so as to avoid the issue of whether the attorney owed a duty to the beneficiary as a client if and when litigation ensues after the settlor's passing.

   c. In close cases, such as, for example, where the attorney has had a long relationship with the principal beneficiary of the new client's

estate plan, the attorney should refer the potential client to another attorney.

2. <u>Undue Influence Suspected</u>. What if the attorney suspects undue influence is being exerted on the client by a potential beneficiary?

   a. The attorney should meet with the client outside the presence of the potential beneficiary, and preferably without the potential beneficiary being present in the immediate vicinity (for example, not present at the attorney's office while the attorney is meeting with the client).

   b. If the testamentary instrument makes a gift that the attorney believes will create suspicions of undue influence, the attorney should consider including statements in the instrument that squarely address those potential suspicions and that carefully document the client's motives in making the gift.

      > Example: "I recognize that my children John and Sally may not understand my reasons for giving a larger share of my estate to my daughter Jane. They may believe that Jane influenced me to give her a larger share of my estate, and they may consider challenging the validity of this instrument. I state unequivocally that Jane has not asked me to make a larger gift to her, nor is she even aware that I am doing so. I have given very careful consideration to my testamentary affairs, and I affirm that the dispositions made in this instrument reflect my decisions, which I have carefully and unequivocally reached after careful deliberation and after seeking the advice and counsel of my attorney J. Doe, who has prepared this instrument at my direction. My attorney and I are initialing here, ________ (Testator), ________ (Attorney), to reflect my attention to and understanding of this paragraph."

   c. The attorney should keep a checklist of the various indicia that courts have relied upon to determine the existence of undue influence and make sure that those indicia are not present or are kept to a minimum. *See, e.g.*, 80 Am.Jur. 2d Will § 970 *et seq.* (1975 and Supps.); "Evidentiary Issues Involving Pre-Execution Practice and Drafting," March 2001 presentation of the Evidence Subcommittee of the Fiduciary Litigation Committee, ACTEC Annual Meeting (March 2001) (hereinafter "Evidentiary Issues"). For example, the attorney should be careful not to deliver

possession of the testamentary instrument to a beneficiary who might be suspected of exerting undue influence.

d. If the attorney believes that the client is being unduly influenced by a beneficiary, does the attorney have a duty to the client or to the client's other beneficiaries to inquire and to document the attorney's belief in file notes or other papers? What are the potential conflicts if the attorney represents multiple family members – parents and children? At what point does the attorney's participation in the estate planning expose the attorney to liability for tortious interference with rights of inheritance? If the attorney makes a record in the client's file of suspicions of undue influence, consider whether those records can be used in seeking to establish liability against the attorney. *See Restatement of the Law (Third), The Law Governing Lawyers, §51* (American Law Institute West 2000); Illustration 4 (lawyer who has drafted a will for a client subsequently found to lack testamentary capacity, as a result of which client's will was set aside, is not subject to liability to heir in heir's suit for expenses incurred in the successful will contest: "Recognizing a duty by lawyers to heirs to use care in not assisting incompetent clients to execute wills would impair performance of lawyers' duty to assist clients even when the clients' competence might later be challenged." Query: Does (should) this rationale extend to cases of undue influence?) For further discussion of the lawyer's duties to a client with diminished capacity, *see Restatement, §24*.

3. Medical Examination. If the client is concerned about challenges based on undue influence, does it make sense to have the client undergo a medical examination to determine his or her susceptibility to undue influence? Should the attorney take the proactive step of having the client examined when there are indicia of undue influence?

C. Execution Formalities in General

1. Standardized Procedures. As noted above, it is critically important that the attorney have standardized procedures governing the preparation and execution of testamentary documents. Preferably, those procedures should be encompassed in a written procedures or office manual. If procedural irregularities in the execution of a testamentary instrument are later alleged, evidence about the existence of standardized procedures and the routine observance of those procedures in the office may overcome such allegations even if the attorney and the witnesses do not recall anything about the circumstances in which the document was executed.

2. Supervision of Execution. The attorney should discourage a client who wants to execute testamentary instruments outside the attorney's office

and without the supervision of the attorney. If the client insists and if the circumstances require execution under those circumstances, the attorney should deliver a written memorandum to the client explaining the formalities required for execution, expressed in very clear and simple terms. The client should be asked to sign and return the memorandum after the execution ceremony, acknowledging that the instructions were followed. A copy of that memorandum and transmittal letter (or other evidence of its delivery) should be kept in the client's file.

D. General Preventive Measures

1. Serial Documents. If a will or trust contest is likely, the attorney should consider having the client execute a series of testamentary instruments over an extended period of time. Instead of bringing one challenge to one instrument, a contestant would face the expensive and difficult prospect of having to set aside multiple instruments in order to get to intestacy or to a prior testamentary instrument favorable to the contesting party.

2. Attorney Notes. The attorney should consider the litigation consequences of notes made by the attorney. Are detailed or less detailed notes better? The attorney should also consider the malpractice implications of notes. In some states, under certain circumstances less detailed notes may provide better insulation against claims of malpractice in estate planning. In general, however, the better practice is to keep detailed file notes of the client's instructions and communications. Caveat: The attorney's practices should be consistent and consistently followed and should dove-tail with the policies instituted by the attorney's firm governing the retention and destruction of client documents generally. Generally, retention of even superseded testamentary instruments is recommended not only because such a record leaves a "paper trail" of the estate planning client's expressed intentions over time but also because the absence of such documents may be adversely commentated on by counsel for a contestant to a later document. *See*, "Evidentiary Issues" (ACTEC 2001). Additionally, superseded documents may come back into play if a contestant is successfully challenges a later executed document.

3. Confidentiality Issues. The attorney should be conscious of preserving the confidentiality of the client's estate planning documents and avoiding inadvertent waiver by disclosure to others during the client's lifetime. Disclosure of testamentary documents to third parties during client's lifetime (for example, to a brokerage firm which insists on having a copy of the trust instrument) could result in a waiver of the attorney-client privilege.

    a. After the client's death, as a matter of state law of **evidentiary** privilege (and not necessarily of professional ethics), attorney-client communications relevant to any material issue concerning

the client's testamentary dispositions are generally discoverable. *See, e.g., Swidler & Berlin v. U.S.*, 118 S.Ct. 2081, 141 L.Ed. 2d 379 (1998):

> "[T]he general rule with respect to confidential communications . . . is that such communications are privileged during the testator's lifetime and, also, after the testator's death unless sought to be disclosed in litigation between the testator's heirs." [Citation omitted.] The rationale for such disclosure is that it furthers the client's intent. [Citation omitted.] Indeed, in *Glover v. Patten*, 165 U.S. 394, 406-408, 17 S.Ct. 411, 416, 41 L.Ed. 760 (1897), this Court, in recognizing the testamentary exception, expressly assumed that the privilege continues after the individual's death. The Court explained that testamentary disclosure was permissible because the privilege, which normally protects the client's interest, could be impliedly waived in order to fulfill the client's testamentary intent. [Citations omitted.]"

b. California's evidentiary rules are typical.

> "There is no privilege . . . as to a communication relevant to an issue between parties all of whom claim through a deceased client, regardless of whether the claims are by intestate or intestate succession or by *inter vivos* transaction." Cal. Ev. Code. §957. *See also*, Ev. Code §959 (no privilege with respect to communications with lawyer/attesting witness); §960 (no privilege with respect to intention of deceased client concerning "a deed of conveyance, will or other writing," executed by the client and affecting an interest in property); §961 (no privilege with respect to communication relevant to an issue concerning the validity of a deed of conveyance, will or other writing).

> The ACTEC Commentary on MRPC 1.6 observes:

> "*Obligation After Death of Client*. In general, the lawyer's duty of confidentiality continues after the death of a client. Accordingly, a lawyer ordinarily should not disclose confidential information following a client's death. However, if consent is

given by the client's personal representative, or if the decedent had expressly or impliedly authorized disclosure, the lawyer who represented the deceased client may provide an interested party, including a potential litigant, with information regarding a deceased client's dispositive instruments and intent, including prior instruments and communications relevant thereto. A lawyer may be impliedly authorized to make appropriate disclosure of client confidential information that would promote the client's estate plan, forestall litigation, preserve assets, and further family understanding of the decedent's intention. Disclosures should ordinarily be limited to information that the lawyer would be required to reveal as a witness." *ACTEC Commentaries* at 73.

Following the death of an estate planning client, however, the estate planning lawyer should be cautioned to review not only the applicable state law of privilege but also the state's ethics rules for insight into whether or not confidential communications with the now deceased testator may be ethically disclosed absent a formal waiver of the privilege or court proceedings. What about possible disclosure issues when the attorney represents both husband and wife? What can and should be disclosed when you have joint representation?

4. **Review of Relevant Documents**. Often times, clients fail to provide their attorney with documents that are pertinent to their estate plans. Knowing that the client will most likely not remember to provide the attorney with all relevant documents, the attorney should be prepared to ask the client for all relevant documents. What should the attorney ask for?

   a. Current estate planning documents;

   b. Marriage settlement agreements related to a divorce decree;

   c. Prenuptial or postnuptial agreements;

   d. Deeds for all real property;

   e. Entity documents – operating agreements, partnership agreements, corporate bylaws;

   f. Estate planning documents for which the client is a beneficiary; and

g. Beneficiary designations on life insurance policies, retirement plans, etc.;

III. AVOIDING SUITS FOR ALLEGEDLY IMPRUDENT INVESTMENTS

A. Drafting Suggestions. Suits against a fiduciary for making allegedly imprudent or improper investments can be discouraged if not effectively prevented altogether through careful drafting of the testamentary instrument.

1. Delegation. Under the Uniform Prudent Investor Act it is possible to delegate one or more investment functions to agents, and if the fiduciary observes standards of care (and in some states, gives notice of the delegation of authority), it is at least theoretically possible to insulate the fiduciary from liability for investments.

> Example: "The trustee may delegate one or more investment functions with respect to any assets held as part of the trust estate to one or more investment agents selected by it. The trustee may delegate any part or all of the investment functions that a prudent investor of comparable skills might delegate under the circumstances, if the trustee exercises reasonable care in selecting the investment agent, in establishing the scope and specific terms of the delegation, and in reviewing periodically the agent's actions in order to monitor overall performance and compliance with the scope and specific terms of the delegation."

2. Overriding the Duty to Diversify. If appropriate, the testamentary instrument should include provisions that dilute or override completely the duty to diversify investments. Such clauses should go further than traditional exoneration language which authorizes the fiduciary to retain original investments. *Cf. First Alabama Bank v. Spragins*, 515 So. 2d 962 (Ala. 1987).

a. If the client has large holdings in a particular company or industry sector that would expose the fiduciary to liability for "uncompensated risk" under modern portfolio theory, the testamentary instrument should specifically identify the company or industry sector, express why the client believes it important to maintain those holdings, and exonerate the fiduciary from liability for following those directions.

> For example: "The trustee may retain the original assets it receives for as long as it deems best, and may dispose of those assets when it deems advisable, regardless of the sizeable value of those

> interests in relation to the other assets held as part of the trust estate, without any duty to diversify investments that otherwise exists under the prudent investor rule or any other rule of law. In particular, the Trustee is expressly authorized to retain a controlling interest in the stock of Widgets, Inc., which the Trustor acknowledges comprises a substantial portion of the trust estate and which prudence might otherwise dictate be disposed of in whole or part. No decision by the Trustee to retain all or any part of Widgets, Inc., if taken in good faith, may be challenged by any beneficiary hereunder."

Note that such provisions may ultimately prove adverse to the client's intended beneficiaries, however, and therefore it may be more advisable to adopt a middle ground approach that stresses the importance of maintaining certain holdings and that permits the fiduciary to maintain an imbalanced portfolio. Such an approach clearly exposes the fiduciary to greater potential liability for substandard investment performance.

3. Special Trustees. It may be advisable to draft the testamentary instrument to create a special investment trustee or agent to manage special assets, or to delegate exclusive authority over certain investment functions to a co-fiduciary. If this option is selected, be sure to specifically identify the scope of the special trustee's duties (i.e. to make clear that the duties are limited to exercising the power/authority in this provision only).

> Example: "The Individual Trustee then serving may remove (and at his or her sole election subsequently reinstate) the investment and voting authority of the Corporate Trustee at any time with respect to all or any portion, amount or assets of the trust estate, by written directions signed by the Individual Trustee and given to the Corporate Trustee. The Individual Trustee will be solely responsible for the exercise of the investment and voting authority removed from the Corporate Trustee. The Individual Trustee may exercise the investment and voting authority so removed in a manner that does not conform to the Corporate Trustee's standard investment models. The Corporate Trustee will have no duty and no power to question the investment management decisions removed from its authority, and it will have no duty to make any investment review of the assets removed from its authority. The Corporate Trustee will have no liability for failure to implement measures over the remaining portion of the trust estate in which it does participate in making investment

decisions that would counter the effects or consequences of investment decisions that were removed its authority (including, without limit, compensating measures to achieve diversification, hedging techniques, or other risk reduction techniques). The Corporate Trustee will be indemnified and held harmless from any damage or liability of any nature that may be imposed upon it because of exercise by the Individual Trustees of the authority under this clause."

4. Exoneration Clauses. In their extreme, clauses that exonerate the trustee from any fiduciary duty to monitor the performance of investment agents or to challenge the actions of investment agents could have adverse tax consequences and could even jeopardize characterization of the arrangement as a trust. For example, if the trustee of a marital deduction trust has no ability to direct investments in income-producing assets, and if the investment agent has no fiduciary duties beyond the ordinary duty to exercise care under the business judgment rule, the marital deduction could be jeopardized (assuming that the spouse was not given the right to require investment in productive assets). Another danger with a broad exoneration clauses is the unintended insulation of an imprudent trustee. During life, the named successor trustee may be a friend or confidant of the settlor, but after death, that friend or confidant may turn on the beneficiaries. An overbroad exoneration clause may leave the beneficiaries with little or no recourse. Finally, with regard to the duty to diversify, the question remains whether an exoneration clause will be valid.

5. Total Return Trusts. Use of total return trusts may serve to minimize or eliminate disputes between competing classes of beneficiaries, particularly conflicts that involve "principal" versus "income" interests.

B. Administrative Safeguards. Observance of proper operating procedures in the administration of the fiduciary estate will greatly reduce the risk of litigation over investments.

1. Written Policies. The trustee (particularly an individual trustee) should have a written statement of investment procedures, policies and objectives that take into account the specific terms and purposes of the trust. That statement should be prepared at the beginning of the fiduciary relationship, and should be reviewed, preferably at least annually. An attorney representing an individual fiduciary should advise the fiduciary to prepare such a statement and assist the fiduciary in preparing it if necessary.

2. Record Retention. The fiduciary must maintain records of periodic investment reviews, such as minutes, notes, and correspondence. This is

particularly critical because liability under the prudent investor rule is for failure to observe standards of care in making investments (rather than specific investment performance).

IV. AVOIDING SUITS OVER TRUST DISTRIBUTIONS

A. **Clear Drafting**. Drafting the testamentary instrument to avoid ambiguities, to provide clear guidance to the trustee in the distribution standards to be applied, and making the extent of the trustee's authority clear is critical to avoid litigation over discretionary distributions. Such clauses should help insulate the trustee from any beneficiary's second-guessing. This can arise in a whole variety of contexts, including invasion of principal, treatment of assets inside a wholly owned company for purposes of calculating income and principal, equalizing distributions if certain assets go up or down in value from the time of drafting or for life time gifts. Here is a sample relating to principal invasions:

> "In exercising its discretion to make distributions to or for the benefit of a beneficiary under this Section, the Trustee shall consider the needs of the remainder beneficiaries to be subordinate to the interests of the current [primary] beneficiaries. No good faith decision to invade principal for the benefit of a current beneficiary shall be subject to challenge by any remainder beneficiary."

B. **Protectors**. Including provisions that appoint advisory committees or protectors to assist the trustee by recommending or authorizing distributions will help to prevent suits by disappointed beneficiaries. Even if they do not prevent litigation, at the least they will help insulate the trustee from liability. However, it is important to clearly define the role and the duties of a trust protector because ambiguity may lead to further litigation.

C. **Safety Valves**. Inclusion of "safety valves" will help prevent litigation over the trustee's distribution decisions. Examples include withdrawal rights given to a beneficiary limited either by the "5 and 5" safe harbor rules or by ascertainable standards, or by appointing the beneficiary to serve as a co-trustee and limiting the beneficiary-trustee's powers to ascertainable standards as defined in the Internal Revenue Code.

V. AVOIDING SUITS OVER FAMILY BUSINESSES

A. **Family Business Situation**: It is sometimes difficult to plan for a family business when the patriarch and matriarch want to treat the children equally, but not all of the children are involved in the family business. With most family businesses, the patriarch and matriarch's goal is to see that the family business is carried on when they pass and that there is harmony amongst their children. Easy solution – provide each of the children with an equal ownership share of the business. Will

this work? In some cases yes, but in many cases no. This in fact may be a recipe for unanticipated, emotional, family destroying litigation. Here are some of the issues -

1. Who is going to run the business after the matriarch and patriarch pass away?

2. What rules will govern the management of the business?

3. How is the wealth of an operating business distributed to a family member not involved in the business?

B. Planning for the Next Generation.

1. Succession Plan.[1] It is imperative that the patriarch and matriarch define their succession plan, including who is to take over and what the management structure will look like. It is also imperative that the patriarch and matriarch communicate this to their children. Finally, it is imperative that the estate planning lawyer clearly state the family business goals in the estate planning documents.

2. Governance Provisions. When one or more of the children are not involved in the business, it is important to have business governance provision in place. In most cases, this includes having unrelated third parties serve as business advisors. The outside third parties can provide checks and balances so that the children running the business treat the other children fairly (e.g., fair and regular distributions, prevent excessive compensation, etc.) Without governance provisions, the settlors run the risk of having the children in the business favoring themselves through the use of excessive salaries, spinning off the lucrative part of a business into a separate entity or squeezing out the non-participatory child through minimal distributions.

VI. AVOIDING SUITS OVER ALLEGED BREACHES OF TRUST OCCURRING DURING SETTLOR'S LIFETIME

A. Trustee's Duty. Who does the trustee owe his or duty to when the settlor is still living? It was once perceived that as long as the trust was still revocable and the settlor had the capacity to revoke the trust, the only person the trustee owed a duty to was the settlor. However, this perception was tossed aside with the California

[1] Based on the Roles and Rules concept developed by John Ambrecht, Esq. and detailed in "For Love & Money" (authors Ambrecht, Berens and Goldwater).

Supreme Court's decision in *Estate of Giraldin* (2012) 55 C. 4th 1058. The Court in *Giraldin* held that after the death of the settlor, the remainder beneficiaries had standing to bring a breach of trust action against the trustee for alleged breaches of trust against the settlor during his or her lifetime.

B. **Effect on Planning**. In light of the holding in *Giraldin*, what should the trustee be doing while the settlor is still living?

1. Accurate records. Even if the trust waives the requirement of an accounting while the settlor is still living, the trustee should keep accurate financial records in the event that a remainder beneficiary demands an accounting after the settlor's death.

2. Advancement of gifts. If possible, satisfy small pecuniary gifts during lifetime so as to eliminate standing as to that beneficiary.

3. Accountings. The trustee may decide to actually provide accountings to contingent remainder beneficiaries so as to start the clock running on any objections that could made against the trustee. Be sure to include the 180 day shortened time period for raising objections and be sure to secure the trustors' consent to reveal this information during his/her/their lifetime

4. Consents. With a cooperative settlor, the trustee may decide to obtain consents from all contingent remainder beneficiaries before engaging in any suspect transaction. For example, if there is a possible issue of self-dealing, it is probably in the best interest of the trustee to obtain consents.

5. Court Approval. If the trustee is unable to obtain consents, it may be in the settlor's and trustee's best interest to seek court approval of the trustee's action or inaction.

VII. PREVENTIVE MEASURES GENERALLY

A. **Engagement Letters**. Engagement letters that clearly identify whom the attorney does and does not represent, and clearly setting forth the scope of the engagement, should be maintained for all clients. *See Engagement Letters: A Guide for Practitioners (for Use with the ACTEC Commentaries on the Model Rules for Professional Conduct)* (ACTEC Foundation, 2d Ed, 2006). (Both the *Guide* and the *ACTEC Commentaries* can be accessed on the public side of the ACTEC website.) It should be made clear that the attorney is not providing services beyond those specifically agreed upon in the engagement letter.

> Example: "Our work will be limited strictly to the legal services described specifically in this letter. We have not agreed to provide and you should not rely on us for business, investment, accounting, or valuation decisions, or to investigate the character or credit of other persons or

> firms (such as insurance companies or investment advisers), unless otherwise specified in the letter."

B. **Independent Review; Document Retention**. Independent review by another "set of eyes" of testamentary instruments before execution is prudent from the standpoints of both litigation avoidance and malpractice prevention. All law firms should have policies (preferably in writing) requiring review by a second attorney of all testamentary instruments before execution. If review before execution is not possible because of time constraints, review should be required as soon after execution as possible. Attorneys in individual practices should make whatever arrangements are possible for an independent review that will preserve client confidentiality, such as working arrangements with other attorneys for review (whether on a paid or unpaid basis). Journals with duplicate (or electronic) copies of all executed instruments should be maintained, particularly when original documents are given to the client.

C. **No-Contest Clauses**.

1. General Use. The use of no-contest ("in terrorem") clauses should be employed to the extent allowed by the governing law. When the client is making significantly less substantial provisions for a natural object of the client's bounty, the attorney should consider including a provision in the testamentary instrument explaining the situation, although detailing specific reasons for the disparate treatment should normally be avoided. For example, the following language might be utilized:

> "I recognize and understand that I have intentionally failed to provide for my daughter. My son Joe is treated more favorably than my daughter Sarah. I have carefully considered the disposition of my estate and declare that said unequal treatment reflects my intentions."

2. Probable Cause. California Standard for Direct Contests. In California, Probate Code Section 21311 provides that a no contest clause will be enforceable against a direct contest brought without probable cause. A direct contest is defined in the code as a contest for forgery, lack of due execution, lack of competence, menace, duress, fraud, undue influence, revocation in certain circumstances, and disqualification of the beneficiary as having witnessed the will or being a prohibited transferee.[2] What can be done post-death to thwart a potential contest action? What about voluntarily producing evidence (the would otherwise be subject to discovery in a contest action) prior to the filing of a contest action? There may be those instances where the personal representative or successor trustee can voluntarily produce enough evidence whereby the no contest

[2] Cal. Prob. Code Section 21310(b).

clause would arguably be enforceable because the potential contestant, with the voluntarily produced evidence, has no probable cause. Without the safe harbor provision for no contest clauses, the proposition of bringing a contest with such evidence may prove too risky for the potential contestant.

3. Pre-death Contract. Instead of providing for a testamentary gift and relying on a no-contest clause, can the settlor enter into a pre-death contract to make a gift? In the right situation, it may be prudent for the settlor to explore whether it makes sense to provide a disfavored beneficiary (e.g., estranged child) with a nominal gift in exchange for the promise not to bring a contest action post-death.

D. Creative Use of Powers of Appointment. A difficult or litigious beneficiary often can be discouraged from bringing litigation by giving someone else a power of appointment (exercisable in a non-fiduciary capacity) that may be exercised at any time to divest the beneficiary of all beneficial interests in the trust. Care must be exercised to ensure that the power will not be characterized as a general power of appointment with respect to the powerholder (as would be the case, for example, if divesting the current beneficiary would cause the trust assets then to accumulate for the benefit of or pass to the powerholder). Depending upon applicable state law, powers of appointment can be granted to trusted persons and eliminate the rights of contingent or remainder beneficiaries to trust accountings, among other things. Remember: "The power to appoint includes the power to disappoint."

E. Exoneration Clauses. Exoneration clauses providing a lesser or greater standard of care may be appropriate and helpful in avoiding litigation. However, caution should be exercised when using broad exoneration clauses because it may be difficult for a beneficiary to bring a valid claim for breach of a fiduciary duty against a guilty trustee. Different standards of care can be applied for different fiduciaries.

> Example: "The trustee will be held harmless from and indemnified against any damage or liability of any nature that may be imposed upon the Trustee because of any actions or omissions while serving as trustee. This protection, however, does not extend to an individual trustee's actions or failures to act that are willful, grossly negligent or made in bad faith, or to a corporate trustee's actions that are negligent."

F. Attorney-Witness Issues. If litigation is anticipated, the attorney should consider entering into an agreement with the client to compensate the attorney for time and expenses incurred if the attorney is required to testify as a witness. However, state law and ethics rules should be consulted to insure enforceability and ethical

compliance. See, "So You are Going to be a Witness?", 24 *ACTEC Notes* 261 (Spring 1999).

G. Choice of Law; Multiple Trusts.

1. The attorney should consider employing choice of law clauses to select other jurisdictions that have more favorable laws with respect to matters that might be subject to litigation. For example, if the law of a state that ordinarily would govern a matter provides that *in terrorem* clauses are ineffective (as is the case in Florida, for example), the attorney should consider a choice of law clause invoking the law of another state (such as California) that enforces *in terrorem* clauses. It may be necessary to take steps such as appointing a co-trustee in the other state to invoke the nexus necessary for application of the other state's law.

2. Rather than putting all of the client's "eggs in one basket," if the circumstances warrant it, multiple separate trusts can be created in a variety of jurisdictions, making it exceedingly difficult for a frustrated or disgruntled beneficiary to achieve total success in an attack. Monumental tax and administrative complications would be involved in such an arrangement, however. For example, the multiple trust rules under the Internal Revenue Code could cause the various trusts to be aggregated and treated as one trust for income tax or generation-skipping tax purposes, even with disparate trustees who act without coordinating their actions with each other. Furthermore, providing choice of law and situs options places a duty on the trustee to examine the cost/benefit to the beneficiaries of moving a trust to a different jurisdiction.

H. ADR Mechanisms. The estate planning attorney should always consider including alternative dispute resolution clauses in testamentary documents. Even if the use of ADR to resolve disputes cannot be mandated in a testamentary document, it is often possible to draft provisions that will provide substantial incentives to the affected beneficiaries to invoke ADR to resolve disputes. In California, however, the use of ADR clauses is not enforceable.[3]

> Example: "If there is a dispute or controversy of any nature involving the disposition or administration of this trust, I direct the parties to the dispute to submit the matter to mediation or some other method of alternative dispute resolution selected by them. If a party refuses to submit the matter to alternative dispute resolution, or if a party refuses to participate in good faith in such process, I authorize the court having jurisdiction over this trust to award reasonable costs and attorney's fees from that party's beneficial share

[3] *McArthur v. McArthur*, 224 Cal. App. 4th 651 (2014) (arbitration clause not enforceable with respect to a trust); *Estate of Carpenter*, 127 Cal. 582 (1900) (arbitration clause not enforceable in a probate estate).

> or from other amounts payable to that party (including amounts payable to that party as compensation for service as personal representative or trustee) as in chancery actions."

VIII. CONCLUSION

As the foregoing discussion reflects, numerous disputes, often predictable, often not, can arise following the estate planning client's death (or incapacity). Careful, conscientious, and forward-looking drafting will dramatically reduce the likelihood of a given dispute and, if the unavoidable dispute does arise, may pave the way for a resolution of the dispute favorable to the client's estate plan and intended beneficiaries.

IX. APPENDICES:

CALIFORNIA WILL ATTESTATION CLAUSE

Exhibit A

The foregoing instrument, consisting of ___ pages, including this attestation page, signed by the witnesses, was, on this date, signed by Susan Testator and declared by her to be her Will, in the presence of us, who, at her request and in her presence and in the presence of each other, have subscribed our names as witnesses thereto. Each of us observed the signing of this Will by Susan Testator and by each other subscribing witness and knows that each signature is the true signature of the person whose name was signed.

Each of us is now more than eighteen years of age and a competent witness and resides at the address set forth after his or her name.

We are acquainted with Susan Testator. At this time, she is over the age of eighteen years, and to the best of our knowledge she is of sound mind and is not acting under duress, menace, fraud, misrepresentation, or undue influence.

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

[Add witness names and addresses, etc.]

CALIFORNIA DEVELOPMENTS

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CALIFORNIA CASES

Estate Planning

1. **Mental Capacity to Execute Trusts and Spousal Undue Influence Presumption**

   Lintz v. Lintz **(2014) 222 Cal.App.4th 1346**

   a. This cases addresses the mental competency necessary to execute complex estate plan documents as well as the application of the Family Code spousal undue influence presumption.

   b. At the time of his death, Decedent, a wealthy real estate developer, was married to his third wife.

      i. Decedent had three children from two prior marriages.

      ii. Wife had two children from a prior marriage.

   c. The Ninth Amendment to Decedent's trust governed his estate plan at the time of his marriage to Wife in 2005. The Ninth Amendment provided that his entire estate went to his children and grandchildren.

   d. Three months after marrying Wife, Decedent executed the Tenth Amendment to his trust, which gave Wife one-half of his trust and his children and grandchildren the other one-half.

   e. Over the next three years, Decedent executed a number of additional amendments to his trust, all of which gave Wife progressively more of his estate to the detriment of his children and grandchildren, ultimately disinheriting his two older children. Decedent's final testamentary act was to execute a joint trust with Wife, which designated all of his assets as community property, gave Wife an interest in Decedent's estate for life, and provided Wife with power to disinherit Decedent's youngest child in favor of her own children.

   f. Upon Decedent's death, his two oldest children filed a complaint against Wife challenging the joint trust and all trust amendments executed after May 2005 (the

Tenth Amendment) on the basis of incapacity and undue influence. The children also alleged that Wife committed financial elder abuse and breached her fiduciary duty to Decedent.

g. After a fifteen-day trial, the court found that, although Decedent had capacity to execute the joint trust and trust amendments, the documents were the product of Wife's undue influence and that Wife was liable for financial elder abuse and breach of fiduciary duty. The Court of Appeal affirmed the decision.

h. With respect to the incompetency issue, although the Court of Appeal ultimately affirmed the lower court's determination that Decedent had capacity to execute the joint trust and amendments, it held that the lower court had erroneously applied the Probate Code Section 6100.5 standard of testamentary capacity.

i. Adopting the reasoning in *Anderson v. Hunt* (2011), 196 Cal. App. 4th 722, the Court found that Probate Code Section 6100.5 is not applicable to trust instruments that are "unquestionably more complex than a will or codicil." The documents at issue were more complex because they "addressed community property concerns, provided for income distribution during the life of the surviving spouse, and provided for the creation of multiple trusts, one contemplating estate tax consequences." Accordingly, the lower court should have applied the "sliding-scale contractual standard in Probate Code Sections 810 through 812."

j. With respect to the undue influence issue, the Court also held that the lower court erroneously failed to apply the presumption of undue influence set forth in Family Code section 721. Under section 721, spouses owe each other a fiduciary duty that prohibits one spouse from taking "any unfair advantage over the other." Pursuant to this duty, "[i]f one spouse secures an advantage from [a] transaction, a statutory presumption arises . . . that the advantaged spouse exercised undue influence . . . ."

k. The joint trust and amendments advantaged Wife by "granting her an exclusive and virtually unfettered life estate in [D]ecedent's property, disinheriting two of [his] three children, and giving [her] the right to disinherit [his] third child and pass [his] property either to her own children or to her individual estate." Despite the error, the Court upheld the finding of undue influence, which was largely supported by circumstantial evidence that Wife "exerted undue influence specifically 'to procure estate plans and control over assets, according to [her] wishes and contrary to'" those of Decedent.

l. The Court highlighted that Decedent was "helpless and susceptible to [Wife's] wishes and influence beyond [what] is normal [in] a marital relationship." Decedent was also afraid of Wife and was "unable to exercise his free will over her when it came to his money." Moreover, Wife took an "active role" in procuring the joint trust and amendments by misinforming Decedent's lawyers of his wishes and, ultimately, by firing them "under the pretext of a fee dispute."

Decedent also signed the joint trust "outside the presence of his new counsel and against new counsel's advice." Finally, the joint trust was inconsistent with Decedent's stated intention to include his youngest child, whom he adored, as a beneficiary and his proven dislike for one of Wife's children.

m. With respect to the financial elder abuse issue, the Court of Appeal also affirmed the lower court's decision that Wife committed financial elder abuse under Welfare and Institutions Code section 15610.30 when she spent enormous sums of Decedent's money by purchasing items on Decedent's credit card without his knowledge or consent and writing herself checks from Decedent's bank account.

2. **Test for Donative Transfer Under Former Probate Code 21350**

***Jenkins v. Teegarden* (2014) 230 Cal.App.4th 1128**

a. This case addresses whether a transfer for some, albeit inadequate, consideration constitutes a donative transfer under Former Probate Code Section 21350.

b. In 2007, Decedent transferred Property A to his Caregiver. Caregiver prepared the quitclaim deed and purported to give Decedent, as consideration for Property A: (1) $100,000 for improvements to Property A, $45,000 in equity in a different property and her caregiving services.

c. After Decedent's death, a beneficiary of Decedent's trust brought an action to invalidate the deed under former Probate Code Section 21350, which invalidates transfers pursuant to documents prepared by unrelated donees.

d. The trial court held that there was no donative transfer that would invoke the Probate Code Section 21350 because good consideration was given for the transfer.

e. The Court of Appeal reversed, holding that there was a donative transfer and that the deed is invalid.

f. Former Probate Code Section 21350 (which has since been repealed and replaced by Probate Code Section 21380, commonly known as the caregiver statutes) provided that a donative transfer to an unrelated drafter of an instrument was invalid unless it was reviewed by an independent attorney or approved by a court. Under that statute, a donative transfer includes not only a transfer of zero value but also a transfer for unfair or inadequate consideration.

g. The court found that the $100,000 of improvements was not adequate consideration since it was used to improve the very property that Caregiver was going to receive as part of this transaction. Furthermore, Decedent, and not Caregiver, owned the other property, including the $45,000 of equity that Caregiver promised to transfer as part of the transaction. Finally, the Caregiver was compensated for her caregiving services both before and after the transaction.

Litigation

1. **Enforceability of Trust Arbitration Provisions**

   ***McArthur v. McArthur* (2014) 224 Cal.App.4th 651**

   a. This case involves the enforceability of an arbitration provision contained in a trust instrument.

   b. Decedent created a trust in 2001 under which her three daughters were designated as equal beneficiaries.

   c. In 2011, Decedent amended the trust allocating a greater portion of the trust estate to Daughter 1 and adding an arbitration clause requiring arbitration of all disputes related to the trust.

   d. After Settlor's death, Daughter 2, who had been disadvantaged by the amendment, brought an action to invalidate the 2011 trust amendment on the grounds of undue influence and lack of capacity and for damages against Daughter 1 for financial elder abuse.

   e. Daughter 1 moved to compel arbitration of the disputes pursuant to the arbitration clause contained in the trust.

   f. The trial court held that Daughter 2 was not bound by the arbitration provision contained in the trust instrument, and the Court of Appeal affirmed.

   g. The Court of Appeal reasoned that even if the 2011 trust amendment was valid, the arbitration clause was unenforceable against Daughter 2 because she had not accepted or sought to enforce benefits under the 2011 amendment. In doing so, the court distinguished this case from other recent cases enforcing arbitration clauses against parties who are not signatories to the trust or the contract (*Pinnacle Museum Tower Assn. v. Pinnacle Market Development* (2012) 55 Cal.4th 223 and *Ruiz v. Podolsky* (2010) 50 Cal 4th 838*)*. Also, since the Probate Code contains no specific legislative authorization for pre-dispute trust arbitration, the court reasoned that the doctrine of delegated authority was not applicable in the context of the trust.

   h. Daughter 1 argued that Daughter 2 was, in effect, a third party beneficiary of the trust agreement and should be bound by the arbitration provision as such. The court disagreed, finding that Daughter 2 was not analogous to a third party beneficiary because she was not claiming any benefits under the 2011 amendment but, rather, attempting to set it aside.

2. **Standing to Contest Codicil Nominating Co-Executors**

   ***Estate of Sobel* (2014) 225 Cal.App.4th 771**

   a. Objectors Jay Rose ("Rose") and Fred Maidenberg ("Maidenberg") appealed from two May 2013 Probate Court orders appointing co-executors, and denying objectors' competing petitions, where objectors sought to be appointed as executor. The orders were affirmed by the Court of Appeal because the objectors lacked standing to contest the codicil.

   b. Rose was named executor in Sobel's original will. A few months before she died, Sobel executed a codicil which removed Rose as executor and appointed three new co-executors, but did not change dispositive provisions of the will. Objectors contested the codicil on the grounds of elder abuse and undue influence by one of the three newly named executors and argued they were "interested" under Probate Code Section 48. Maidenberg acknowledged he had no interest in the outcome of the matter, and was denied standing. Rose asserted standing to challenge the codicil as the named executor in the original will.

   c. California courts had held that an executor could contest a subsequent will, though he had no beneficial interest in the estate, on the theory that he represents those who would be entitled to the estate under the will. Here, however, because the codicil did not change dispositive provisions, but only changed the executor, the court found that Rose did not have standing to challenge the codicil.

   d. The objectors also argued that the Probate Court has the inherent power and duty to determine whether the codicil was procured by undue influence irrespective of a contestant's standing. The court rejected the argument, stating that while the Probate Court may raise an undue influence challenge on its own motion, it is not obligated to do so.

3. **Standing to Apply Fraud Presumptions**

   ***Vance v. Bizek* (2014) 228 Cal.App.4th 1155**

   a. Trustee was also a beneficiary under an irrevocable trust. In the face of a creditor claim, trustee attempted to disclaim her interest under the trust.

   b. Creditor brought an action to set aside the disclaimer on the grounds that the trustee accepted benefits of the trust by commingling her personal funds with the trust's and using such funds.

   c. The trial court ruled in favor of the creditor. It applied the presumption under Probate Code Section 16004, which states:

      "[a] transaction between a trustee and a beneficiary ... by which the trustee obtains an advantage from the beneficiary is presumed to be a violation of the trustee's fiduciary duties. This presumption ... affect[s] the burden of proof."

d. By applying the presumption, the trial court ruled that the burden of proof shifted to the trustee to prove that her commingling of funds did not constitute acceptance of benefits under the trust.

e. The Court of Appeal reversed finding that the Probate Code 16004 presumption can only be applied in disputes between a trustee and beneficiary, not between a trustee and her personal creditor.

f. Accordingly, the creditor had the burden of proving the trustee accepted benefits under the trust; it failed to do so.

4. **Standing to Bring Malpractice Case Against Prior Conservator's Attorney**

***Stine v. Dell'Osso* (2014) 230 Cal.App.4th 834**

a. This case involves whether a successor conservator can bring a legal malpractice action against the attorney for the prior conservator.

b. The Court of Appeal opinion reverses a demurrer that was granted by the trial court, so all facts recited in the opinion are facts as plead by the plaintiff and not facts as found by a trier of fact.

c. According to the complaint, in 2002 Son hired Attorney to represent him in establishing a conservatorship of the estate over his mother. In the petition to establish the conservatorship, Son alleged that there were no assets of the conservatorship since all assets were held by mother's trust. Despite that allegation, mother had substantial assets outside of her estate that would ordinarily be part of the conservatorship estate, including real property and individual retirement accounts.

d. In 2003, the court appointed Son as conservator of the person and estate and waived bond, relying on Son's representation that the conservatorship estate contains no assets. Plaintiff alleges that Attorney represented Son following his appointment as conservator and that she knew of mom's assets outside of the trust that should have been inventoried in the conservatorship. Plaintiff also alleges that Attorney knew the Son had marshalled those assets, was controlling them and monitored and assisted Son with the management and control of those assets.

e. Despite this knowledge, and contrary to the mandate of Probate Code Section 2320.1 (which requires the conservator and the conservator's attorney to make an *ex parte* application for an order increasing bond when the conservator knows that a bond is insufficient), Attorney did not independently notify the court of the non-inventoried assets.

f. Ultimately, Son misappropriated over a million dollars of assets and was removed as conservator in 2010. The successor conservator, a private

professional fiduciary, brought an action against Son for financial elder abuse and against Attorney for legal malpractice.

g. The trial court sustained Attorney's demurrer on the grounds that the attorney-client relationship was with Son and not with the Conservatee, so Attorney had no duty of care to the Conservatee, and alternatively, the successor conservator is subject to any defense that could have been used against Son, including the fact that Son had unclean hands.

h. The Court of Appeal reversed. Although an attorney is normally liable only to the client with whom the attorney stands in privity of contact, the successor fiduciary exception applies in this case. Under the successor fiduciary exception, the successor fiduciary has standing to sue the attorney for the predecessor fiduciary because the successor fiduciary assumes all powers of the predecessor, including the power to assert the attorney-client privilege and to sue for malpractice. The court found that the California Supreme Court case of *Borissoffv v. Taylor & Faust* (2004) 33 Cal.4th 523 did not limit the successor fiduciary exception only to those claims where the predecessor fiduciary instructs the attorney to do a specific action.

i. The court also found unpersuasive Attorney's argument that if the successor fiduciary is to hold all powers of the predecessor fiduciary, the successor fiduciary should also be limited by all defenses that could be asserted against the predecessor fiduciary. The court reasoned that a fiduciary wears two hats when serving in that role, one as the fiduciary and one as the individual. When Son misappropriated assets, he was wearing his hat as an individual and not acting within the scope of his duties as a fiduciary. As a result, any defenses that could be asserted against Son do not bind a successor fiduciary.

5. **<u>Sole Trustee, Settlor and Beneficiary may appear in *pro per*</u>**

Aulisio v. Bancroft (2014) Court of Appeal, 4th Appellate Dist., 3rd Div.

a. This case addresses whether the settlor, trustee and sole beneficiary of a revocable trust can appear in court *in pro per* or whether an attorney is required to represent the trust in court.

b. Plaintiff, both individually and as trustee, sued his homeowner's association for damages resulting from the homeowner's association towing his car. The car was owned by Plaintiff's revocable trust.

c. Plaintiff, as trustee of his trust, originally appeared in court through an attorney, but he eventually began to appear in court representing himself *in pro per*. The trial court found that a trust may not appear in court *in pro per* and that doing so amounted to the unauthorized practice of law.

d. The Court of Appeal reversed. In situations where a trust has only one settlor, trustee and sole beneficiary, all interests of the trust are unified in a single person

and that single person can appear *in pro per* because he is not representing the interests of other people or entities. The court distinguished situations where a trust creates multiple interests, in which case an *in pro per* appearance by the trustee is not permitted because the trustee would be representing the interests of multiple people, thereby engaging in the unauthorized practice of law.

6. **Appeal Dismissed Because of Disentitlement Doctrine**

***Blumberg v. Minthorne* (2015) Court of Appeal, 4th Appellate District**

a. Husband and Wife created a joint revocable trust in 2008. Each of them had children from a prior marriage.

b. Among other assets, Husband transferred to the trust an apartment building he previously owned and Wife transferred two residences she previously owned.

c. The trust instrument contained two conflicting provisions that controlled the disposition of assets upon the death of the first spouse to die. The first gave the entire trust estate to a survivor's trust completely revocable and amendable by the surviving spouse. The second gave certain property to the surviving spouse and the balance to children and grandchildren of the deceased spouse.

d. After Husband's death, Wife became the sole trustee of the trust. Her attorney, the drafting attorney, informed all beneficiaries that the trust would be distributed pursuant to the second clause (splitting the beneficial interest between the surviving spouse and issue of the deceased spouse). The effect of this distribution was to provide Wife one-half of the apartment building (as well as personal effects and liquid assets) but no interest in the two properties she originally transferred to the trust. She did not object to her attorney's interpretation of the trust document and began to administer it accordingly.

e. During the administration, Wife never produced an accounting to Husband's grandchildren despite their request. She also sold the apartment building (as was permitted by the trust instrument) and received as a distribution one-half of the sale proceeds (also as permitted by the trust instrument).

f. She later sold one of the residences she contributed to the trust and used the sale proceeds to purchase another residence (the Hesperia residence). She took title to the Hesperia residence in her own name and not in the name of the trust.

g. Husband's grandson filed a petition to remove Wife as trustee, compel an accounting and recover the Hesperia residence for the trust. The trial court granted the grandson's petition. Wife was removed as trustee, ordered to convey the Hesperia residence to grandson as the successor trustee and to account. The hearing on the accounting was scheduled for December 18.

h. The day before the hearing on the accounting, Wife filed a Notice of Appeal. She did not file an accounting or execute a deed. The next day at the hearing, the

trial court judge set an Order to Show Cause hearing on the accounting and deed for January 29.

i. On January 28, the day before the OSC hearing, Wife conveyed the Hesperia residence to her daughter. On that same day, she filed a response to the OSC arguing that the Notice of Appeal stayed the trial court's orders but voluntarily agreed to file an accounting within 60 days. She did not disclose that she had conveyed the Hesperia residence to her daughter.

j. At the OSC hearing (which was continued to February 13), the court ordered that by March 6 Wife was required either to convey the Hesperia residence as ordered or post a $90,000 undertaking. She was ordered to file her accounting by March 27.

k. Neither Wife nor her counsel appeared at the March 6 hearing. The court lifted the stay imposed by the Probate Code and ordered the court clerk to execute a deed conveying the Hesperia residence to grandson as trustee. Wife and her counsel failed to appear at a subsequent hearing.

l. Grandson filed a motion in the Court of Appeal to dismiss Wife's appeal based on the Disentitlement Doctrine.

m. The Court of Appeal granted grandson's motion.

n. Under the Disentitlement Doctrine, a Court of Appeal may dismiss an appeal if a party refuses to comply with a lower court order.

o. The trial court's orders in this case were enforceable and not stayed by the pending appeal. Probate Code Section 1310(d) provides that an appeal does not stay an order if the "court requires an undertaking as provided in [CCP 917.9] and the undertaking is not given." Code of Civil Procedure Section 917.9 provides that an appeal does not stay an order if the trial court ordered an undertaking and either "(1) Appellant was found to possess money or other property belonging to respondent [or] (2) Appellant is required to perform an act for respondent's benefit pursuant to [the order] under appeal."

Trust Administration

1. **<u>Investment Fund Manager Breached Fiduciary Duty to Trustee</u>**

   Hasso v. Hapke **(2014) 227 Cal.App.4th 107**

   a. This case serves as a cautionary tale for trustees who rely on the direction of others for investment advice.

   b. In 2006, Grandparents created irrevocable trusts for the benefit of grandchildren.

c. A lifelong family friend and business associate of grandparents was named as initial trustee.

d. A friend of Daughter (the parent of some beneficiaries) told her about an interesting hedge fund investment opportunity. Daughter sought information about the investment on behalf of the trusts. The year was 2007.

e. The CEO and CFO of the fund made a presentation to Daughter to pitch their "municipal arbitrage" investment strategy. Although the written materials disclosed that investments in hedge funds can be risky, they assured Daughter that the strategy was low risk, appropriate for trusts, and would provide a nearly guaranteed annual return of 8% or 10%. CEO said that in the worst case scenario the trusts would lose 10% of their value. The trustee was not present at the meeting.

f. After the meeting, the CEO sent a private placement memorandum to the trustee. Following the direction of the Daughter, the trustee invested $6 Million in the hedge fund.

g. The hedge fund lost 80% of its value in the 2008 financial crises. Grandson, a beneficiary, sued the hedge fund, the CEO, and the CFO for, among other things, breach of fiduciary duty.

h. The jury awarded a $4.6 Million judgment against all defendants.

i. The Court of Appeal affirmed as to the hedge fund itself and the CEO, but it reversed as to the CFO. Under Corporations Code Section 25009(a), only the hedge fund and CEO are "investment advisors" who owed a fiduciary duty.

j. Clearly, the beneficiaries had a very good cause of action against the trustee for improper delegation of duties.

2. **<u>Abatement Statutes Do Not Prohibit Sale During Settlor's Lifetime</u>**

***Siegel v. Fife* (2015) Court of Appeal, Second Appellate District**

a. Settlor created a revocable living trust in 2005. The trust provided a specific gift of a house and cash to Friend with the expressed intent that Friend care for Settlor's cats.

b. Settlor's capacity began to diminish, and ultimately she voluntarily petitioned to be placed under a conservatorship of the estate and person. Her petition was granted and a third party conservator was appointed.

c. The conservator moved Settlor to an assisted living facility. It quickly became apparent that Settlor's income and liquid assets would not be sufficient to support her and provide for her care, and the trustee of the trust placed the house (as well as other property) for sale and petitioned for approval of the sale.

d. Friend objected to the petition for approval of the sale on the basis that the abatement statutes, which require the residue of the trust be used first for the payment of debts, prohibited the sale of the property since it would deprive Friend of her gift before the residue is exhausted.

e. The trial court, finding that the sale of the house was needed to care for Settlor, denied Friend's objections and granted the petition.

f. The Court of Appeal affirmed. Largely dodging the abatement issue, the court found that while Settlor was living Friend was a remainder beneficiary and the trust expressly provided that the interests of the life beneficiary take precedence over the interests of the remainder beneficiary. Also finding that the trustee had the power to sell the house, and that the sale was proper in light of the circumstances of the Settlor, the court found Friend's objections to be without merit.

g. The court expressly did not rule on the impact of the abatement statutes after the death of the Settlor.

3. **General Reference to Real Property in Trust Sufficient for *Heggstad* Petition**

***Ukkestad v. RBS Asset Finance, Inc.* (2015) Court of Appeal, Fourth Appellate District**

a. Trust provided that the Settlor "hereby assigns, grants and conveys to the Trustees of this instrument all of the Grantor's right, title and interest in and to all of his real and personal property . . . wherever situated."

b. Settlor had not executed deeds to two properties before his death. After his death, a potential creditor objected to the Trustee's *Heggstad* petition claiming that the trust instrument did not satisfy the statute of frauds with respect to the real property. Based on that reasoning, the probate court denied the petition.

c. The trustee and the creditor settled, so the creditor did not appear in the appeal.

d. The Court of Appeal overturned the probate court's order. It began by explaining that is it "well established that if two specific requirements are met, real property may be made part of a trust's assets without a separate deed transferring property to the trust." [citing *Heggstad*] Those two requirements are:

   1. The owner of the real property is the Settlor of the trust naming himself or herself as trustee; and

   2. With respect to real property, compliance with the statute of frauds.

e. Addressing the statute of frauds issue, the court found that the statute of frauds is satisfied if the identity of the real property can be determined with reasonable certainty. Reasonable certainty is satisfied with either a certain description or by

providing a "means or key" which, using extrinsic evidence, can be used to identify the property.

f. Here, the real property to be conveyed to the trust was identified as all real property owned by the Settlor wherever situated. Using the county records, which are public, as the means or key, the specific parcels of property can be identified. Accordingly, the statute of frauds is satisfied.

Elder Law

1. **No "Necessities of Life" Exemption for Conserved Tortfeasor**

   Conservatorship of Parker **(2014) 228 Cal.App.4th 803**

   a. This case addresses whether the necessities of life exception to conservatorship debts applies to tortuous acts committed by the conservatee before the imposition of the conservatorship even though the judgment is entered after the imposition of the conservatorship.

   b. The Conservatee and his business partner were in the business of flipping homes.

   c. They found undeveloped land in Lancaster and planned to build condominiums on the land. The jointly hired Attorney to prepare documents to formalize their relationship and to implement the development plan.

   d. Shortly after hiring Attorney, the parties had a dispute that ended their relationship. The Conservatee, with the assistance of Attorney, went forward with the development plan without his former business partner.

   e. The business partner sued Conservatee for breach of contract and breach of fiduciary duty, and he sued Attorney for legal malpractice.

   f. While the lawsuit was pending, a conservatorship was established for Conservatee. After the conservatorship was established, a judgment was entered in favor of the business partner for both compensatory and punitive damages. Attorney paid the punitive damages, and the business partner filed a petition to compel the Conservator to pay the compensatory damages.

   g. The Probate Court held that the Conservatee's debt to his business partner (in the form of the judgment) predated the conservatorship "because the debt was incurred at the time the tort occurred" and held that the debt must be paid regardless of whether doing so would impair the ability of the Conservator to provide the necessities of life to the Conservatee.

   h. The Court of Appeal affirmed. Under Probate Code Section 2430(a)(1), a conservator is required to pay from the conservatorship estate any debts incurred by the Conservatee before the creation of the conservatorship, regardless of whether doing so would impair the conservator's ability to provide for the

necessities of life of the conservatee. By contrast, Probate Code Section 2430(b) allows a conservator to pay debts arising after the establishment of the conservatorship if doing so would not impair the conservator's ability to provide for the necessities of life of the conservatee.

i. The court found that in tort cases the relationship of debtor and creditor arises at the moment the cause of action accrues even if the amount of the damages and the ultimate judgment is not determined until an award is made. Accordingly, in this case, the debt accrued before the conservatorship was established regardless of whether the judgment was entered afterwards.

j. The court found unpersuasive the fact that former Probate Code Section 1858 excepted debts before and after the establishment of the conservatorship if payment of debts would deprive the conservatee of the necessities of life. In current Probate Code Section 2430 as enacted, the Legislature removed the exception for debts incurred before the conservatorship, and the court found that the Legislature intended to change the law in doing so.

2. **Assumption of Risk with Alzheimer's Patient**

***Gregory v. Cott* (2014) 59 Cal.4th 996**

a. This case involves whether the assumption of risk doctrine protects an Alzheimer's patient against an action by home health care workers.

b. Caregiver was trained to care for Alzheimer's patients and understood them to be potentially violent. In 2005, Caregiver was assigned by an agency to work in an Alzheimer's patient's home. Patient's husband informed Caregiver that the Patient could be combative.

c. Nearly three years after being on the job and caring for Patient on a daily basis, Caregiver was injured. The injury stemmed from an altercation that occurred between Caregiver and Patient while Caregiver was washing a knife. When Patient reached for the knife, Caregiver restrained Patient and Patient dropped the knife injuring the Caregiver's wrist, resulting in a loss of feeling in several fingers and recurring pain.

d. Caregiver received worker's compensation for the injury and sued Patient and her husband for negligence and premises liability.

e. The trial court granted the motion for summary judgment brought by Patient and her husband, and the Court of Appeal affirmed on the basis that the primary assumption of risk doctrine applied.

f. The Supreme Court affirmed. After reviewing prior case law applying the primary assumption of risk doctrine to workers who care for Alzheimer's patients in an institutionalized setting, firefighters, and veterinarians, it found that the primary assumption of risk doctrine applies because the defendant, the

Alzheimer's patient in this case, owes no duty of care to guard against a risk of harm that is well known to the worker. Since the Alzheimer's patient owes no duty of care, the primary assumption of risk doctrine operates as a complete bar to recovery by Caregiver.

g. The court limited its holding to home health care workers trained and employed by agencies who care for Alzheimer's patients.

h. The court also found significant the contractual nature of the relationship. The patient's husband had contracted with the agency to be relieved of the duty to protect Caregiver from the very risks that the Caregiver was retained to encounter. The court concluded that it would be against public policy and common sense to allow recovery in such a situation.

3. **<u>Impairment of Property Right can be "Taking" for Financial Elder Abuse</u>**

   Bounds v. Superior Court **(2014) 229 Cal.App.4th 468**

a. This case involves whether a "taking" under the elder abuse statutes requires a transfer of title to property.

b. At the time of the transaction in question, Elder was 88 years old with undiagnosed cognitive impairment. She had a longtime relationship with Neighbors who owned property adjacent to hers. Elder's business was failing and was in need of cash. Consequently, Elder and Neighbors began negotiating for the sale of Elder's property to Neighbors.

c. As part of the negotiations, Neighbors made exaggerated claims about the poor condition of Elder's property in order to frighten Elder into selling it to them at a bargain price.

d. Neighbors persuaded Elder to enter into a Letter of Intent with respect to the sale knowing that the purchase price was well below fair market value and that Elder was not acting with professional advice. A formal purchase and sale agreement was never executed purportedly because Neighbors did not want Elder to seek professional advice. An escrow for the sale of the property was opened using only the Letter of Intent as escrow instructions, and Elder leased the property to Neighbors. Shortly after Letter of Intent was signed, Elder was diagnosed with Alzheimer's Disease.

e. Elder, who believed that negotiations were still ongoing, contacted her attorney regarding the transaction. The attorney attempted to renegotiate the deal on the basis that no purchase and sale agreement had been signed. When Neighbors refused, Elder's attorney terminated the escrow on her behalf.

f. Neighbors demanded that the sale be completed on the terms set forth in the Letter of Intent and filed an action demanding specific performance and recording a *lis pendens* on the property. Elder, in response, filed a cross-complaint

alleging financial elder abuse. Neighbors demurred to the cross-complaint on the basis that there was no "taking" under the elder abuse statutes, and the court granted the demurrer without leave to amend.

g. The Court of Appeal issued a preemptory writ of mandate compelling the trial court to vacate its order sustaining the demurrer and to enter a new order overruling the demurrer holding that Neighbors' actions could constitute a "taking" under elder abuse statutes.

h. Welfare and Institutions Code Section 15610.30(c) defines financial elder's abuse, in part, as occurring when "a person or entity takes, secrets, appropriates, obtains, or retains real or personal property when an elder or dependent adult is deprived of *any property right*, including by means of an *agreement*, donative transfer, or testamentary bequest, regardless of whether the property is held directly or by a representative of an elder or dependent adult." (*Emphasis added)* Even through title to the property had not transferred to Neighbors, the Court of Appeal reasoned that a "taking" had occurred.

i. The escrow instructions and the related lease constituted a significant impediment to Elder's ability to sell the property or borrow against it because the Elder would have to disclose those items to any potential lender or purchaser. The ability to sell and borrow against property constitute property rights, and the impairment of those rights, even in the absence of a transfer of title, can constitute a taking on which an elder abuse claim can stand.

Creditor Rights

1. **<u>Inherited IRA is not a Retirement Assets Exempt from Bankruptcy</u>**

   ***Clark v. Rameker* (2014) 134 S.Ct. 2242**

a. This United States Supreme Court case examines whether an inherited IRA is a retirement asset that is exempt from bankruptcy.

b. Decedent established a traditional IRA and named her daughter as the sole beneficiary of the account. When Decedent died, the $450,000 IRA passed to daughter and became an inherited IRA.

c. In 2010, daughter and her husband filed for Chapter 7 bankruptcy and identified the IRA as exempt from the bankruptcy estate as retirement funds. The bankruptcy trustee and unsecured creditors objected to the claimed exemption.

d. The United States Bankruptcy Court for the Western District of Wisconsin disallowed the exemption. It reasoned that an inherited IRA does not contain retirement funds because they were not segregated to meet the needs of, or dispersed upon, a person's retirement.

e. The U.S. District Court for the Western District of Wisconsin reversed, holding that the exemption covers any account containing funds originally accumulated for retirement purposes.

f. The U.S. Court of Appeal for the Seventh Circuit reversed the District Court because the rules governing inherited IRAs allow for current consumption of the assets such that they are not necessarily funds for retirement.

g. In an unanimous decision, the U.S. Supreme Court affirmed the Court of Appeal decision. It reasoned that the phrase "retirement funds" in the bankruptcy law should be interpreted to apply to funds set aside for the day an individual stops working. Inherited IRAs do not fall within that meaning for three reasons. First, the holder of an inherited IRA may never contribute to the account. Second, the holder of an inherited IRA is required to withdraw money from the account regardless of his or her retirement age. Third, the holder of an inherited IRA may withdraw the entire balance at any time without penalty.

h. The court further reasoned that such interpretation is consistent with the purpose of the bankruptcy exemptions, which are designed to prevent a debtor from being deprived of his or her essential needs. The regular IRA is designed to ensure that a debtor is able to meet his or her essential needs at retirement, whereas an inherited IRA may be consumed by the account owner prior to retirement.

2. **<u>Medi-Cal Recovery from SNT not Barred By Under 55 Limits on Estate Recovery</u>**

Herting v. California Department of Health Services **(2015) Court of Appeal, Sixth Appellate District**

a. Beneficiary was in a catastrophic automobile accident at the age of 19. Net settlement proceeds of approximately $1,800,000 were placed in a court-ordered special needs trust. Beneficiary died 4 years later after having received Medi-Cal benefits.

b. The DHS filed a claim for reimbursement of approximately $400,000 of health care costs it paid. Together with the final account and petition for termination of the trust, the trustee of the special needs trust filed a request for denial of the DHS claim. The trustee's position was that Welfare and Institutions Code Section 14009.5(b)(1) prohibits the DHS from recovering from estates of decedents who received benefits while under 55 years of age unless the decedent was an inpatient in a nursing facility.

c. The DHS argued that under California Code of Regulations, title 22, section 50489.9, a special needs trust must provide, as a condition of qualification, that the DHS receive "an amount equal to the total medical assistance paid on behalf of that individual by the Medi-Cal program." Since the Beneficiary had been deemed eligible for Medi-Cal solely because the special needs trust contained this provision, applying the under-55 limitation would "thwart the intent of the

statute to provide for payback of Medi-Cal expenses [and] would lead to an unreasonable result that is contrary to public policy."

d. Both the trial court and the Court of Appeal agreed. The under-55 limitation to recovery applies only to recovery from a recipient's estate. Since special needs trusts are afforded special treatment by allowing the beneficiary to be eligible for benefits despite otherwise failing the resource limitations to eligibility, the special recovery rules applicable to special needs trusts, under both federal and California law, must be respected. As a result, the under-55 limitation does not apply to recovery from a special needs trust.

Marital Property

1. **Evidence Code Section 662 Form of Title Presumption vs. Family Code Transmutation Statutes**

   In Re Marriage of Valli **(2014) 58 Cal.4th 1396**

a. In this case, the California Supreme Court analyzed the interplay between the form of title presumption embodied in Evidence Code Section 662 and the Family Code transmutations statutes as they relate to the marital property character of assets purchased from a third party.

b. Husband used community funds from a joint bank account to purchase a $3.75 million insurance policy on his life, naming Wife as the sole owner and beneficiary of the policy. All premiums on the policy were paid from community property funds.

c. During the martial dissolution proceedings, Wife testified that she was told by Husband and Husband's business manager that the policy would be hers. Husband did not contradict that testimony, but stated that there was no intent to dissolve the marriage at the time of the purchase and that he was confident that Wife would use the policy for her benefit and the benefit of their joint children.

d. The Family Court held that the policy was community property, rather than Wife's separate property, because it was purchased with community property funds.

e. Wife appealed the Family Court's decision on two grounds:

   1. She argued that the policy was her separate property because the form of title presumption embodied in Evidence Code Section 662 applied and made the property her separate property because she was listed on title as the sole owner of the policy.

   2. She also argued that the Family Code transmutation provisions apply only to inter-spousal transfers and do not apply to property, such as the life insurance policy in this case, that is purchased from a third party.

f. The Court of Appeal reversed the Family Court's decision and held that the policy was Wife's separate property because it was purchased from a third party and no inter-spousal transfer had taken place that would invoke the Family Code transmutation provisions.

g. The California Supreme Court reversed the Court of Appeal's decision and affirmed the trial court's decision. The court found great import in the legislative intent behind the Family Code statutes, which is to simplify what often comes down to a "he said she said" scenario. The court rejected the idea that the Family Code transmutation requirements did not apply to property purchased from a third party. In doing so, the court posed two hypotheticals to illustrate why exempting third party acquisitions from the transmutation requirements of the Family Code would produce arbitrary results.

    1. In the first hypothetical, Husband purchases an expensive necklace for Wife using community funds and then gives the necklace to Wife. In this hypothetical, the court feels that the necklace, because it was purchased with community funds, would constitute community property.

    2. In the second hypothetical, Husband and Wife go to the jewelry store together, purchase the necklace with community funds, and Wife leaves the store wearing the necklace. Using Wife's logic in this hypothetical, the court said that the necklace would constitute Wife's separate property because it was purchased from a third party. The court reasons that the Legislature could not have intended such different and arbitrary results.

h. As to the form of title presumption embodied in Evidence Code Section 662, the court held that it does not trump the Family Code transmutation requirements. In situations where the form of title presumption and transmutation requirements conflict, the Family Code transmutation requirements control.

Property Tax

1. **<u>Assessor May Not Reassess on Theory That Law is Unconstitutional</u>**

   Ocean Avenue LLC v. County of Los Angeles **(2014) 227 Cal.App.4th 344**

   a. This case illustrates a creative way to avoid property tax reassessment upon the sale of an entity owning real property as well as the limits of the County Assessor's authority.

   b. An LLC that was owned by a limited partnership purchased a hotel property in 1999. In 2006, the hotel property was put on the market for sale and a purchase and sale contact was executed.

c. Two months after the purchase and sale contact was executed, it was rescinded by the parties and, on that same day, 100% of the member interest in the LLC that owned the hotel property was sold to Trust (49%), Investment Portfolio (42.5%) and Investor LLC (8.5%). No person acquired more than 50% of the LLC interests.

d. The Los Angeles County Assessor found that no person acquired more than a 50% interest in the LLC, even applying a look-through test. Despite its finding, the County Assessor reassessed the property taking the position that a change of ownership had occurred.

e. The LLC appealed to the County Assessment Appeals Board which upheld the County Assessor's decision that there was a change of ownership on three theories:

   1. The limited partnership had transferred all of its interest in the hotel property.

   2. The original purchase and sale contact for the hotel property was enforceable, so the hotel property transferred in July of 2006 by virtue of the doctrine of equitable conversion.

   3. One individual controlled more than 50% of the capital invested in the purchase.

f. The trial court reversed the Assessment Appeals Board decision and held that no change of ownership had occurred because no person or entity obtained, directly or indirectly, more than a 50% interest in the capital and profits of the LLC.

g. The Court of Appeal affirmed. By the County Assessor's own computations, the largest individual owner of the LLC owned only 47.82%. It rejected the application of the substance over form argument finding that federal income tax doctrines are not applicable to California property tax disputes and that the County Assessor must rely on California, and not federal, law. The court also rejected the equitable conversion argument because there is no equitable conversion when all parties demonstrate a contrary intent by terminating the original contact. Even if the contract were enforceable, the purchaser did not have a present interest in the property that would support an equitable conversion because the contract contained several conditions precedents that had to be satisfied before the purchaser would have what is substantially a fee interest in the property. Finally, the court rejected the County Assessor's argument that the provisions governing this type of transfer under proposition 13 are unconstitutional because the County Assessor is not permitted to reassess property on the theory that legislation is unconstitutional without first obtaining a declaratory relief order to that effect.

Power of Attorney

1. **Bank Not Required to Honor Power of Attorney**

   ***Stern v. Bank of America* (not published)**

   a. This case addresses whether a bank is required to honor the request of an agent under a power of attorney to open an account for the principal.

   b. Son was serving as agent for his mother under a durable power of attorney. Mother was in her 90s, disabled and suffered from Alzheimer's Disease.

   c. Son attempted to open bank accounts at Bank of America for his mother using her power of attorney and presenting Mother's California identification card from the DMV. Although Mother had an existing account at Bank of America, the bank refused to open the account unless she personally came to the bank in order to comply with the bank's policy to guard against fraud and identity theft. Son also approached Wells Fargo Bank attempting to do the same thing, and Wells Fargo Bank similarly refused.

   d. Son filed an action against Bank of America and Wells Fargo Bank on behalf of Mother alleging violations of the Unruh Civil Rights Act (the "Unruh Act") and the Probate Code. The banks filed a demurrer, and the trial court sustained the demurrer without leave to amend. The trial court found that state governments cannot dictate requirements to national banks for opening accounts. Specifically, banks must be allowed to operating in a way that prevents fraud or illegal conduct.

   e. The Court of Appeal affirmed. With respect to the Unruh Act claim, which forbids business establishments from arbitrarily excluding a prospective customer, particularly on the basis of protected characteristics of the customer, the court found that the bank's policy of physical presence was neutral with respect to a customer's race, sex, religion, or other personal characteristics protected by the Unruh Act. Although the bank's policy may have a disparate impact on the disabled, the court found that the Unruh Act only covers intentional acts of discrimination and not disparate impact. Since federal law requires a bank to adopt procedures that will enable it to form a reasonable belief regarding the true identity of each customer, the bank's policy of requiring physical presence merely complies with that federal mandate in a manner that is neutral with respect to the personal characteristics protected by the Unruh Act.

   f. With respect to the Probate Code, the court acknowledged that Probate Code Section 4300 requires third persons to accord an agent under a power of attorney with the same rights and privileges that would be accorded the principal if personally present. The court noted, however, that Probate Code Section 4300 also provides that "a third person is not required to honor the attorney-in-fact's authority or conduct business with the attorney-in-fact if the principal cannot require the third person to act or conduct business in the same circumstances."

Since bank accounts are contractual relationships, mom could not have compelled the banks to open accounts if they were unwilling to do so. Since mom could not compel the banks to open an account for her if physically present, Son as agent under the power of attorney likewise could not do so.

g. The court went on to point out that the banks have a complete defense since Probate Code Section 4406(c) provides that any third party may refuse a power of attorney if "authorized or required by state or federal statute or regulation." Since federal regulations require banks to adopt procedures to ensure the identity of their customers, the bank's policy of requiring physical presence to open an account is in furtherance of that federal requirement and may not be trumped by the Probate Code.

CALIFORNIA LEGISLATION

1. **AB 1888 – Documentary Transfer Tax**

    a. Deletes the requirement that, upon request, the amount of Documentary Transfer Tax Due be shown on a separate documents and not on the face of the transfer documents.

    b. Makes it more difficult, if not impossible, to keep the sale price confidential.

2. **AB 296 – Principal and Income**

    a. Ordinarily under the CUPIA, receipts attributable to a partial liquidation of an entity are allocated to principal.

    b. This bill creates an exception for receipts of short-term capital gain from a regulated investment company or a real estate investment fund.

3. **SB 940 – California Conservatorship Jurisdiction Act**

    a. Not effective until January 1, 2016.

    b. Provides rules for determining interstate jurisdiction, transfer and recognition of conservatorships under the Act.

    c. CCJA does not apply to proceedings involving a minor, LPS (or similar involuntary proceedings), adults with developmental disabilities, and includes limitations on its applicability to conservatees with dementia.

    d. Provides rules to determine whether a California court has jurisdiction and, if it does not, provides for emergency relief in special circumstances.

    e. Provides for communication between courts concerning proceedings under the CCJA.

    f. Establishes procedures that will apply to determine jurisdiction and transferring jurisdiction.

4. **SB 1050 Notaries**

    a. Changes the jurat to include a disclosure stating that jurat verifies only the identity of the signer and not the truthfulness, accuracy, or validity of the document.

PORTABILITY: THE BASICS AND BEYOND

By S. Andrew Pharies, Esq. and Erin E. Norberg, Esq.[1]

After much debate, the American Taxpayer Relief Act (ATRA)[2] was signed into law by President Obama on January 2, 2013, putting an end to over a decade of uncertainty about estate tax rates and exemptions. ATRA made permanent the temporary changes made by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Act),[3] which had ushered in a new era for estate planning by reunifying the unified credit for estate tax and gift tax at $5,000,000, providing that the unified credit is to be adjusted for inflation in future years, and introducing the new concept of "portability."

I. THE BASICS OF PORTABILITY

Portability is perhaps the most important concept introduced in transfer tax law since the unlimited marital deduction, and it will impact millions of Americans.[4] In simple terms, portability means that if, when the first spouse dies, the value of his or her taxable estate plus adjusted taxable gifts is less than his or her federal exemption from estate taxes, the surviving spouse can take (or "port") the unused exemption amount and use it, in addition to the surviving spouse's own exemption, to make lifetime or testamentary gifts.[5]

A. Applicable Exclusion Amount (AEA)

What is popularly known as the estate tax "exemption" is actually a credit against the estate tax measured as the tentative tax determined under Internal Revenue Code ("IRC" [6]) section 2001(c) if the amount with respect to which the tax was computed was equal to the applicable exclusion amount (AEA). For years prior to 2011, the AEA was defined as a single dollar figure. For example, in 2009 the AEA was $3,500,000, and in 2010 the AEA was $5,000,000. As a result of the 2010 Act, as made permanent by ATRA, for deaths occurring after December 31, 2010, an additional element has been added to the computation of the AEA. The AEA for a surviving spouse is now defined as

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1 DLA Piper LLP (US), San Diego, California.

2 Pub.L. No. 112-240 (Jan. 2, 2013).

3 Pub.L. No. 111-312 (Dec. 17, 2010).

4 Of the approximately 2,728,000 people in the U.S. who had a net worth of $1,500,000 or higher in 2004, 86% of them had a net worth of $5,000,000 or below. See *The 2012 Statistical Abstract*, U.S. Census Bureau, Table 718.

5 Temporary regulations addressing portability were released by the IRS on June 15, 2012, and are due to expire on June 15, 2015, but are likely to be finalized before expiration. See Temp. Treas. Regs. sections 20.2010-1T, 20.2010-2T and 20.2010-3T.

6 All references to "IRC" or the "Code" are to the Internal Revenue Code of 1986, as amended, unless stated otherwise.

the sum of (i) the basic exclusion amount (BEA) and (ii) the deceased spousal unused exclusion amount (DSUE Amount).[7]

1. Basic Exclusion Amount (BEA)

The BEA is a set dollar amount adjusted for inflation.[8] For 2015, the BEA is $5,430,000,[9] which represents the base BEA of $5,000,000 plus an inflation adjustment of $430,000. Unlike the DSUE Amount, described below, the BEA is not a static number, but will continue to adjust for inflation over time.[10]

2. Deceased Spousal Unused Exemption Amount (DSUE Amount)

At the heart of portability is the DSUE Amount. The DSUE Amount looks to the estate tax attributes of a surviving spouse's most recently deceased spouse, if that deceased spouse died after December 31, 2010. In that case, the DSUE Amount of a deceased spouse is the lesser of (A) the BEA in effect in the year of the deceased spouse's death, or (B) the excess of (i) the deceased spouse's AEA, over (ii) the amount on which the tentative tax on the deceased spouse's estate is determined.[11]

> *Example 1*: Assume Husband dies in 2015 with a taxable estate of $2,000,000, all of which is given to Child. Wife's AEA in 2015 will be $8,860,000, consisting of her 2015 BEA of $5,430,000 plus a DSUE Amount of $3,430,000 (computed as her deceased spouse's BEA of $5,430,000 less the $2,000,000 given to Child). In 2016, Wife's BEA will increase for inflation, but the DSUE Amount component of her AEA will remain at $3,430,000. If Congress reduces the BEA in the future, the DSUE Amount will remain at $3,430,000.

B. Portability Election Made by Filing Estate Tax Return

For estates of decedents dying in 2012 and later, the "executor"[12] must complete and timely-file[13] an estate tax return, Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return, to elect portability of the DSUE Amount to the surviving spouse.[14] Form 706 now includes a Part 6 – Portability of Deceased Spousal Unused

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[7] IRC section 2010(c)(2).
[8] IRC section 2010(c)(3).
[9] Rev. Proc. 2014-61, 2014-47 IRB 860 (Nov. 17, 2014), section 3.33.
[10] IRC section 2010(c)(3)(B).
[11] IRC section 2010(c)(4); Temp. Treas. Regs. section 20.2010-2T(c)(1).
[12] See the discussion at Section VII(B), below, for further information regarding who may qualify as the executor for purposes of the Portability Election.
[13] A timely-filed return is one that is filed on or before the due date of the return, including extensions. Temp. Treas. Regs. section 20.2010-2T(a)(1).
[14] Temp. Treas. Regs. section 20.2010-2T(a).

Exclusion, which includes a computation of the DSUE Amount.[15] This filing requirement applies to all estates of decedents choosing to elect portability of the DSUE Amount, regardless of the size of the estate. The timely filing of a Form 706 with DSUE Amount will be deemed a "Portability Election" if there is a surviving spouse.[16] The election is effective as of the decedent's date of death, so the surviving spouse may use the DSUE Amount for any transfer occurring after the decedent's death without further action.[17] Once the election to port the DSUE Amount is made and the due date for filing the decedent's estate tax return (including extensions) has passed, the Portability Election is irrevocable.[18]

1. Special Rules If Estate Tax Return Not Otherwise Required

When a deceased spouse's gross estate is less than his or her AEA so that a Form 706 is not required, the requirement that a Form 706 must be filed to port the DSUE Amount to the surviving spouse creates an administrative burden and expense. The Temporary Regulations allow a modified filing procedure for estates in this situation.[19] Executors of such estates are not required to report the value of property that qualifies for the marital or charitable deduction.[20] If an executor chooses to make use of this special rule in filing an estate tax return, the value of those assets must be estimated to the nearest $250,000 and included in the total value of the gross estate. The estimate must be based on a determination made in good faith and with due diligence, but formal appraisals are not required. [21]

2. Opting Out of Portability

There are two ways to opt out of portability: (i) the executor filing the estate tax return affirmatively opts out by checking the box in Section A in Part 6 of Form 706; or (ii) no Form 706 is timely filed for the decedent's estate.[22]

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15 Temp. Treas. Regs. section 20.2010-2T(b). Prior to the revision of Form 706, effective for decedents dying in 2011, the IRS provided guidance in IRS Notice 2011-82 that a calculation of the DSUE Amount was not required and that merely filing the return was sufficient to make the election.

16 Temp. Treas. Regs. section 20.2010-2T(a)(2).

17 Temp. Treas. Regs. section 20.2010-3T(c).

18 Temp. Treas. Regs. section 20.2010-2T(a)(4); Revenue Procedure 2014-18 allowed a late Portability Election for U.S. citizen decedents who died between December 31, 2010, and December 31, 2013, and who were not otherwise required to file a Form 706. To qualify for the late filing, a Form 706 had to have been filed on or before December 31, 2014.

19 Temp. Treas. Regs. section 20.2010-2T(a)(7)(ii).

20 Temp. Treas. Regs. section 20.2010-2T(a)(7)(ii)(A). Exceptions to this rule are set forth in Temp. Treas. Regs. sections 20.2010-2T(a)(7)(ii)(A)(1) through (4) and include assets: (1) the value of which affects the value of assets passing to other recipients; (2) the value of which is needed to determine qualification under IRC section 2032, 2032A, 6166, or any other provision of the Code; (3) in which only a partial interest is included in the gross estate; and (4) that are the subject to a partial disclaimer or a partial QTIP election.

21 Temp. Treas. Regs. section 20.2010-2T(a)(7)(ii)(B).

22 Temp. Treas. Regs. section 20.2010-2T(a)(3).

C. Extended Statute of Limitations

IRC section 2010(c)(5)(B) extends the statute of limitations for examining a Form 706 of a surviving spouse's deceased spouse whose DSUE Amount is claimed to be included in the surviving spouse's AEA. Since the DSUE Amount can be computed only after considering all estate tax attributes of the deceased spouse's estate, the entire Form 706 of the deceased spouse will remain subject to examination for an indefinite period of time if the Portability Election is made. However, while the IRS may adjust or eliminate the DSUE Amount in connection with any gift or transfer at death by the surviving spouse that uses any DSUE Amount, the IRS may not assess additional tax on the deceased spouse's estate after the statute of limitations has run for the decedent's return.[23]

D. DSUE Amount Not Indexed for Inflation

While the BEA component of the AEA is indexed for inflation, the DSUE Amount component of the AEA is not so indexed. As a result, the DSUE Amount component of a surviving spouse's AEA will lose value over time, relative to inflation.

E. DSUE Amount Used Before BEA

On its face, IRC section 2502(a) does not specify whether a surviving spouse's BEA or the DSUE Amount from a prior spouse is used first. This becomes an important question in the context of successive marriages. For example, assume that Wife has an AEA of $7,430,000 consisting of her BEA of $5,430,000 and a DSUE Amount of $2,000,000 from Husband 1. Wife then marries Husband 2. If Wife predeceases Husband 2 and leaves her entire estate, consisting of $4,000,000, to her children, how large is the DSUE Amount that can be ported to Husband 2? If Wife's BEA is applied first, the DSUE Amount would be only $1,430,000 (the difference between Wife's $5,430,000 BEA and the amount left to her children). If Wife's DSUE Amount from Husband 1 is applied first, then the DSUE Amount available to Husband 2 would be $3,430,000 (the $4,000,000 left to the children would be sheltered by the $2,000,000 DSUE Amount from Husband 1 first, then by $2,000,000 of Wife's BEA, leaving $3,430,000 for Husband 2).

The Joint Committee on Taxation commented on this issue in a report discussing portability.[24] Much to the surprise of most practitioners, the Joint Committee on Taxation took the position that the DSUE Amount would be used before the surviving spouse's BEA,[25] and the IRS has adopted that position in the Temporary Regulations.[26]

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23 Temp. Treas. Regs. section 20.2010-3T(d).

24 J.C.T.Rep. No. JCX-55-10 (2010).

25 *Id*. at p. 51, Ex. 3 under "Portability of unused exemption between spouses."

26 Temp. Treas. Regs. sections 25.2505-2T(b) and 20.2010-3T(b).

F. Not Applicable to GST

There is no provision for porting a deceased spouse's unused generation-skipping transfer tax exemption.

II. PORTABILITY AND GIFT TAX PLANNING

IRC section 2505(a) provides that the unified credit for gift tax is the applicable credit amount in effect under section 2010(c) that would apply if the donor died as of the end of the calendar year, reduced by any applicable credit amount used by the donor in prior years.[27] Since the applicable credit amount under Section 2010(c) includes the DSUE Amount of a deceased spouse, the surviving spouse may use the DSUE Amount for gift tax purposes, as well as for estate tax purposes. When a taxable gift is made by a surviving spouse who holds a DSUE Amount, the DSUE Amount is applied first and the surviving spouse's BEA is applied only after the DSUE Amount is exhausted. It is important to note that the available DSUE Amount that a surviving spouse may use for gift tax purposes is determined as of the date of the taxable gift.[28]

III. PORTABILITY AND SUCCESSIVE MARRIAGES

While the basic concept of the DSUE Amount is relatively simple, it becomes considerably more complex when one considers the impact of successive marriages. Remarriage alone does not affect the DSUE Amount. Rather, IRC section 2010(c)(4)(B)(i) makes clear that in calculating the DSUE Amount one may consider only the unused AEA of the decedent's last deceased spouse.

A. Subsequent Deceased Spouse Leaves Different DSUE Amount

Since only the last deceased spouse's AEA can be considered in computing the DSUE Amount of a surviving spouse, it is possible that a surviving spouse's DSUE Amount could be changed if the surviving spouse remarries and is predeceased by the new spouse who leaves a different DSUE Amount.

> *Example 2*: Wife has a DSUE Amount of $5,000,000 from Husband 1. Wife marries Husband 2 who has a net worth of $4,000,000, all of which is to pass to his children upon his death. Husband 2 dies in 2015 with a BEA of $5,430,000. His executor timely files a Form 706 and makes a Portability Election. As a result, Wife loses her prior DSUE Amount of $5,000,000 from Husband 1 and now has a DSUE Amount of $1,430,000 from Husband 2.

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[27] IRC section 2505(a); Temp. Treas. Regs. section 25.2505-1T(a).

[28] Temp. Treas. Regs. section 25.2505-2T(a)(i). Therefore, even if the DSUE Amount is reduced later in the calendar year as a result of the death of a subsequent spouse, the DSUE Amount in effect at the time a surviving spouse makes a taxable gift is the DSUE Amount of the surviving spouse's last deceased spouse as of the date of the taxable gift.

B. No Portability Election is Made for Subsequent Deceased Spouse

A similar result occurs if the executor of a subsequent deceased spouse's estate fails to make a Portability Election. IRC section 2010(c)(4)(B)(i) makes clear that the DSUE Amount is calculated with reference to the tax attributes of a person's last deceased spouse. The Portability Election merely allows a surviving spouse to use the DSUE Amount as part of the surviving spouse's AEA. If a Portability Election is not made, then the DSUE Amount component of the AEA is simply eliminated. As a result, it is not possible to preserve a DSUE Amount from a prior spouse by intentionally not making a Portability Election at the death of a subsequent spouse.

> *Example 3*: Wife has a net worth of $7,000,000 and DSUE Amount of $5,000,000 from Husband 1. At the age of 75, she marries Husband 2, who has only a few small joint tenancy bank accounts with Wife. Wife survives Husband 2. Since Husband 2 has few assets and no post-death estate administration is required, Wife does not think to consult counsel and does not file a Form 706. Since Wife did not make a Portability Election with respect to Husband 2, she is not able to consider his DSUE Amount as part of her AEA when she dies in 2015. As a result, her AEA is reduced from $10,430,000 ($5,000,000 DSUE Amount from Husband 1 plus $5,430,000 AEA in 2015) to $5,430,000, which will result in estate tax due when she dies.

C. Lifetime Gifts Using DSUE Amount

If a person holds a DSUE Amount from a prior spouse and remarries, it may be wise for that person to use the DSUE Amount of the prior spouse by making lifetime gifts. Using an existing DSUE Amount through lifetime gifts before a subsequent spouse dies not only preserves the use of the prior spouse's DSUE Amount, it could allow a person who survives multiple spouses to use an unlimited number of DSUE Amounts.

> *Example 4*: Husband has $50,000,000 of assets. In 2011, he marries Wife 1, who has no assets. She dies in late 2011 and leaves Husband a DSUE Amount of $5,000,000. In 2012, Husband marries Wife 2, and also makes a gift of $10,120,000 to his children using his entire AEA, including the DSUE Amount of Wife 1. In 2013, Wife 2 dies and leaves Husband a DSUE Amount of $5,250,000. Husband subsequently makes a gift of $5,250,000 to his children using Wife 2's DSUE Amount. Later that year, he marries Wife 3. Wife 3 dies in 2014, leaving Husband a DSUE Amount of $5,340,000. In 2015, Husband dies with Wife 3's DSUE Amount of $5,340,000, plus his BEA of $31,000 (2015 $5,430,000 BEA, minus $5,120,000 used in

2012), totaling $5,650,000. With this multiple marriage strategy, Husband is able to pass $20,741,000 to his children free of transfer tax!

IV. PORTABILITY AND THE NON-RESIDENT ALIEN

The executor of an estate of a non-resident alien[29] (NRA) cannot make a Portability Election.[30]

Interesting issues arise if a U.S. person is married to an NRA. If the U.S. spouse dies first, there is no provision in IRC section 2010(c) that prohibits the DSUE Amount of the U.S. deceased spouse from being ported to the NRA surviving spouse. The fact that the DSUE Amount is ported to the NRA surviving spouse, however, does not mean that the surviving spouse will be able to use it. The DSUE Amount is a component of the AEA only for U.S. persons. If the surviving spouse remains an NRA, his or her unified credit is computed under IRC section 2102, and the DSUE Amount is not considered in computing the unified credit under that section. The Temporary Regulations state the prohibition expressly.[31]

However, if the surviving spouse becomes a U.S. domiciliary or citizen, then it appears that the DSUE Amount will be considered in calculating the surviving spouse's AEA for subsequent gifts and at the surviving spouse's death, even if the surviving spouse was an NRA when the deceased spouse died. If the combined worldwide assets of a married couple is below the AEA that would be available to them if they were both U.S. persons, it may be wise for the NRA spouse to become a U.S. domiciliary or citizen for estate tax purposes in order to take advantage of the AEA available to U.S. persons, which could include the DSUE Amount.

> *Example 5*: Husband and Wife are residents of Mexico City. They own $2,000,000 of property in Mexico as community property and $2,000,000 of real property in California as community property. Husband is a citizen of Mexico. Wife has lived in Mexico her entire life, but she was born in the U.S. and is, as a result, a U.S. citizen. In 2011, Wife dies leaving all of her assets in Mexico and the U.S. to her husband. Her estate plan does not contain QDOT planning for Husband and no post-death QDOT is created for the California real property. Wife's gross estate will be $2,000,000 consisting of an undivided one-half interest in the property in Mexico and the U.S. Since Husband is not a U.S. citizen, no marital deduction applies and $2,000,000 of Wife's AEA is used upon her death.

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29 References to a "non-resident alien" or "NRA" are to a person who is not a U.S. domiciliary for U.S. estate tax purposes and is not a U.S. citizen, regardless of whether the person is a non-resident alien for U.S. income tax purposes.

30 Temp. Treas. Regs. section 20.2010-2T(a)(5).

31 Temp. Treas. Regs. sections 20.2010-3T(e) and 25.2505-2T(f).

> Husband, as executor of wife's estate, makes an election to port Wife's $3,000,000 DSEUA to himself. If Husband remains an NRA, then he will not be able to use the DSUE Amount and he will have an exemption equivalent of $60,000 that he can use to shelter a portion of the California real property from estate tax. As a result, assuming a 40% tax rate, estate tax of approximately $776,000 will be due as a result of his later death. If, however, Husband becomes a U.S. person and dies in 2015, then he would have available to apply against his worldwide assets not only his BEA of $5,430,000 but also predeceased Wife's DSUE Amount of $3,000,000. Husband can become a U.S. person by coming to the U.S. and manifesting a subjective intent to remain in the U.S., which theoretically can be done without becoming a U.S. resident for income tax purposes.

If a qualified domestic trust (QDOT) is created in order to qualify assets passing for the benefit of a non-citizen surviving spouse for the marital deduction under IRC section 2056(d)(2), the ability of the non-citizen surviving spouse to use the DUSEA will be limited, even if the surviving spouse is domiciled in the U.S. and so is not completely barred from using DSUE Amount. The Service's position is clear that the deceased spouse's AEA "first and foremost belongs to the decedent."[32] Consequently, until the amount of the decedent's estate tax is finally determined, which could be delayed until the surviving spouse dies, the surviving spouse is not permitted to use the DSUE Amount.[33] The Temporary Regulations provide a special procedure by which the deceased spouse's executor computes the DSUE Amount on a preliminary basis subject to redetermination upon the occurrence of subsequent taxable events, such as distributions to the surviving spouse that trigger an estate tax under IRC section 2056A.[34] Once the deceased spouse's estate tax is finally determined, either because of the death of the surviving spouse or a termination of the QDOT, the surviving spouse may use the remaining DSUE Amount. Since that final determination will occur no later than the year in which the surviving spouse dies, the Temporary Regulations provide that the surviving spouse may use the DSUE Amount for gifts completed during that year or the year in which the QDOT terminates.[35]

V. PORTABILITY AS A SUBSTITUTE FOR BYPASS TRUST PLANNING

Portability has been offered by Congress as an alternative to bypass trust planning. On a superficial level, this may be true. Portability was designed to allow a surviving spouse to use the AEA of a deceased spouse, so that the deceased spouse's exemption is not wasted, which is one of the objectives of bypass trust planning. However, the only day on which both techniques yield the same economic result is on the

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[32] T.D. 9593, F.R.Doc. 2012-14781 (June 15, 2012), Explanation of Provisions, section 8.

[33] Temp. Treas. Regs. sections 20.2010-3T(c)(2) and 25.2505-2T(d)(2).

[34] Temp. Treas. Regs. section 20.2010-2T(c)(4).

[35] Temp. Treas. Regs. section 25.2505-2T(d)(2)(i).

day the deceased spouse dies. After the deceased spouse's death, as the values of assets change or the law changes, the economic effects of the two techniques can differ significantly and they can have dramatically different consequences. Practitioners must consider these potential consequences on a case-by-case basis and choose the technique that best accomplishes the client's objectives.

Even if bypass trust planning is chosen as the primary method of using the deceased spouse's AEA, portability will still be an issue in most cases. Only in cases where the deceased spouse's taxable estate exceeds his or her remaining AEA will portability not need to be considered. If the AEA stays at high levels, portability planning will remain a constant fixture in estate planning and post-death trust and estate administrations.

A. Benefits of Bypass Trust Planning

Bypass trust planning confers several benefits that cannot be achieved if portability is used as the primary method of using the deceased spouse's AEA.

1. Preventing Reduction of Sheltered Amount

As discussed above, the DSUE Amount of a deceased spouse is the lesser of (A) the BEA in effect in the year of the deceased spouse's death, or (B) the excess of (i) the deceased spouse's AEA, over (ii) the amount on which the tentative tax on the deceased spouse's estate is determined. The BEA is currently $5,430,000 (as adjusted for inflation in 2015), so that is the maximum DSUE Amount of a deceased spouse who dies in 2015. It is possible that the BEA will decrease in future years. If the surviving spouse remarries and survives a later spouse, the DSUE Amount of a prior spouse is lost, as discussed in Section III above.

If clients want to avoid the risk of a losing the DSUE Amount of a deceased spouse, they should opt for bypass trust planning as the primary method for using the deceased spouse's AEA. The amount to be funded into a bypass trust is normally determined by the AEA available in the deceased spouse's estate. Once the bypass trust is funded, subsequent changes in the estate tax laws or the subsequent remarriage of the surviving spouse will not affect the tax-sheltered status of that trust.

2. Sheltering Appreciation

The BEA is indexed for inflation. As a result, the BEA will increase in the future in increments of $10,000 in order to keep up with inflation. The DSUE Amount component of the AEA, however, is not indexed for inflation. As a result, the DSUE Amount ported to a surviving spouse is likely to lose value, relative to inflation, each year that the surviving spouse lives. If a client wants to use his or her AEA in order to shelter the value of current assets as well as the future appreciation on those assets, then bypass trust planning should be the primary method of using the deceased spouse's AEA. Once a bypass trust is funded, the assets allocated to that trust, including the appreciation on those assets, will pass free of estate tax on the death of the surviving spouse.

3. Planning for Blended Families

In blended families, typically, the spouses do not want their assets to be distributed outright to the surviving spouse upon the first death. Rather, while they might want the surviving spouse to benefit from the assets for life, each of them typically wants his or her assets to pass to his or her own children upon the death of the surviving spouse. If portability is used as a substitute for bypass trust planning, the surviving spouse would have full control of the deceased spouse's assets once they pass to him or her outright. Instead, in order to accomplish the clients' objective of allowing each spouse to pass his or her assets ultimately to his or her own children, the deceased spouse's assets should be held in an irrevocable trust for the benefit of the surviving spouse for life, with the remainder to the deceased spouse's children. The terms of that irrevocable trust can guarantee that the remaining assets pass to the deceased spouse's children and eliminate the surviving spouse's ability to control the disposition at his or her death. Such an irrevocable trust can be a bypass trust or a QTIP trust.

4. Creditor Protection

If a bypass trust is drafted as a spendthrift trust, it could protect the trust assets from the creditors of the beneficiaries to the extent permitted under applicable state law.[36] Such creditor protection would not be possible if assets are left outright to the surviving spouse.

5. Generation-Skipping Planning

Portability does not apply to the generation-skipping tax (GST) exemption. As a result, if a deceased spouse's assets are distributed outright to a surviving spouse, the deceased spouse's unused GST exemption will be lost. If instead the deceased spouse creates an irrevocable trust at death, his or her GST exemption can be applied to that trust so that the assets remaining in that trust at the surviving spouse's death can pass to grandchildren (or to a generation-skipping trust that eventually will benefit grandchildren) free of generation-skipping tax. If a client wants to benefit grandchildren after the surviving spouse's death, such an irrevocable trust should be used rather than portability. The irrevocable trust could be either a bypass trust or a QTIP trust.

6. Non-Citizen Spouse

Gifts and bequests to a non-citizen spouse do not qualify for the unlimited marital deduction. As a result, using portability as the exclusive method of using the deceased spouse's AEA would not be appropriate since the assets passing to the surviving spouse would not qualify for the marital deduction. Instead, if assets are left outright to the surviving spouse, the deceased spouse's AEA would be used to shelter the assets passing to the surviving spouse from estate tax, but those same assets would be subject to estate tax when the surviving spouse dies. By using a bypass trust, however, the deceased spouse's AEA can be used in a manner that will shelter the assets from estate tax when the surviving spouse dies. To the extent the deceased spouse's assets exceed his or her

[36] See, e.g., Prob. Code, section 15300 *et seq*.

AEA, traditional QDOT planning would be required to prevent an estate tax on the death of the deceased spouse.

B. Benefits of Portability

1. Basis Adjustment at Second Death

If the estate plan relies on portability to use the deceased spouse's AEA, the deceased spouse's assets will be left to the surviving spouse in a manner that will result in those assets being included in the surviving spouse's gross estate. In that case, the assets will receive a second basis adjustment under IRC section 1014 on the death of the surviving spouse. Conversely, assets held in a bypass trust would not receive such a basis adjustment on the death of the surviving spouse. The benefit of a basis adjustment could be significant if the assets appreciate in value during the surviving spouse's lifetime, or if the estate includes depreciable property so that the basis adjustment could provide a new depreciation base or avoid depreciation recapture upon a post-death sale of the property. If the value of the surviving spouse's estate is likely to be lower than his or her AEA (as augmented by the DSUE Amount), the basis adjustment is achieved without any offsetting estate tax cost.

2. Retirement Benefit Planning

Prior to portability, estate planning for IRAs or defined contribution plans often required clients to make a difficult choice between fully utilizing a participant spouse's AEA or obtaining the income tax benefits of a spousal rollover. With portability, the surviving spouse can make a spousal rollover while still fully utilizing the deceased spouse's AEA by porting the DSUE Amount.

3. S Corporation Planning

Only certain types of trusts are qualified S corporation shareholders.[37] These trusts include grantor trusts, qualified subchapter S trusts (QSSTs), and electing small business trusts (ESBTs).[38] Prior to portability, if an S corporation comprised a large portion of a married couple's assets, the bypass trust had to be structured as either a QSST or ESBT in order to qualify as an S corporation shareholder. Both types of trusts carry certain disadvantages. Structuring the bypass trust as a QSST requires that the trust contain certain dispositive terms that may not be appropriate in some situations.[39] Similarly, if a bypass trust is treated as an ESBT, it would be burdened by certain

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[37] See IRC section 1361(c)(2).

[38] *Id.*

[39] IRC section 1361(d)(3) requires that there be only one income beneficiary of the trust during the lifetime of that beneficiary, that all income be distributed to that beneficiary annually, that any distribution of principal be made only to the income beneficiary, that the income interest must terminate at the beneficiary's death or termination of the trust, and that if the trust is terminated during the lifetime of the income beneficiary the trust principal must be distributed to the income beneficiary.

unfavorable income tax attributes.[40] By using portability, the adverse consequences of a QSST or ESBT can be avoided by giving the S corporation stock to the surviving spouse (or to a revocable trust created by the surviving spouse which qualifies as a grantor trust for income tax purposes) while using the deceased spouse's AEA by porting the DSUE Amount to the surviving spouse.

VI. PORTABILITY AND QTIP TRUST PLANNING

It may be possible to capture some of the benefits of bypass planning while using portability to allow the deceased spouse's assets to receive a second basis adjustment upon the death of the surviving spouse. The deceased spouse can leave his or her assets to a qualified terminable interest property (QTIP) trust rather than to a bypass trust. Since the assets passing to a QTIP trust will qualify for the marital deduction, the deceased spouse's AEA will not be used to shelter those assets from estate tax. That would allow the deceased spouse's executor to port the DSUE Amount to the surviving spouse. When the surviving spouse dies, the assets of the QTIP trust will be included in the surviving spouse's gross estate under IRC section 2044 and will receive a basis adjustment under IRC section 1014, and the surviving spouse's AEA would be increased by the DSUE Amount, effectively allowing the use of both spouses' exemptions at the time of the surviving spouse's death.

A. Blended Family Planning

QTIP trusts have long been used to protect the assets of the deceased spouse in blended family situations. A QTIP trust is an irrevocable trust of which the surviving spouse is the sole beneficiary for life. Upon the death of the surviving spouse, the assets of the trust are distributed to the beneficiaries designated by the deceased spouse. Therefore, a QTIP trust can provide a level of blended family planning comparable to a bypass trust. Of course, in order for a trust to qualify as a QTIP trust, the surviving spouse must be given a qualified income interest, no other person may receive any portion of the principal of the trust during the surviving spouse's lifetime, and the surviving spouse must have the right to compel the reinvestment of the trust assets in order to make them income producing.[41] If the deceased spouse wants his or her children to hold a present beneficial interest in the trust during the lifetime of the surviving spouse, or if the trust consists of assets, such as a family business, that should not be sold, then a QTIP trust may not be an appropriate solution, and the client may be better advised to rely on traditional bypass trust planning.

B. Creditor Protection

If a QTIP trust includes a spendthrift clause, it would provide creditor protection that is comparable to a bypass trust (except for the income that must be distributed to the surviving spouse each year).

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[40] IRC section 641(c) provides that an ESBT's income from an S corporation must be taxed at the trust level and be subject to the highest marginal individual tax rate.

[41] IRC section 2056(b)(7)(B).

C. GST Planning

While a bypass trust can be used to capture the deceased spouse's GST exemption, it is not the exclusive method of doing so. A reverse QTIP election under IRC section 2652(a)(3) can be made with respect to a QTIP trust to allow the deceased spouse's GST exemption to be allocated to the assets held in a QTIP trust.

> *Example 6*: Husband and Wife each have children from a prior marriage. Wife owns an apartment building with a value of $3,000,000 as her separate property. If she dies first, she wants Husband to continue to receive the income from the apartment building, but she wants the apartment building to pass to GST trusts for the benefit of her children and grandchildren upon Husband's death. If possible, she would like the apartment building to receive a basis adjustment when Husband dies in order to give her children and grandchildren a new depreciation base. Husband and wife also own $4,000,000 of community property that she wants to pass to Husband outright upon her death. This estate plan could provide a specific gift of the apartment building to a QTIP trust. Husband would receive the net income of the QTIP trust for his lifetime, but the remainder would pass to trusts for Wife's children and grandchildren upon Husband's death. The balance of Wife's assets would pass to Husband. Wife's estate plan documents would direct her executor to make a QTIP election with respect to the QTIP trust, to make a reverse QTIP election with respect to the QTIP trust in order to allocate her GST exemption to it, and to port her DSUE Amount to Husband. Upon Wife's death in 2015, her AEA is $5,430,000. Since the QTIP trust qualifies for the marital deduction, Wife's entire $5,430,000 DSUE Amount passes to Husband. During Husband's lifetime, the apartment building held in the QTIP trust is protected from his creditors and he cannot alter the disposition of that asset. Upon Husband's death, he has an AEA of $10,860,000 (including Wife's DSUE Amount), which is more than enough to shelter all of the assets, including the asset in the QTIP trust, from estate tax. Since the apartment building held in the QTIP trust is included in Husband's gross estate under IRC section 2044, it receives a basis adjustment upon his death. As a result, the trusts for Wife's children and grandchildren receive the building with a new tax basis, thereby receiving a new depreciation base and mitigating the effects of a depreciation recapture upon a later sale. Also, since the apartment building is held in GST trusts, it will not be subject to estate tax for the foreseeable future.

D. Caution: Revenue Procedure 2001-38

In Revenue Procedure 2001-38[42], the IRS stated that it will not consider a QTIP election valid if it is not necessary to reduce the estate tax of the decedent. On its face, Revenue Procedure 2001-38 seems to preclude the type of QTIP planning described above, since a QTIP election is not technically necessary to reduce the decedent's estate tax. However, one must keep in mind that Revenue Procedure 2001-38 was designed as a relief measure to avoid punishing people who inadvertently made a QTIP election for a bypass trust. No provision in the Internal Revenue Code specifically prohibits an intentional QTIP election with respect to a trust where failing to make a QTIP election would not result in estate tax. However, until Revenue Procedure 2001-38 is modified, practitioners should be cautious when using QTIP planning in conjunction with portability.

E. Using the QTIP Election to Shift the Deceased Spouse's AEA

In second marriage situations, if the surviving spouse is the executor of the deceased spouse's estate and has the power to make a QTIP election, the surviving spouse may have an opportunity to manipulate the estate plan of the deceased spouse to provide a net benefit to the surviving spouse's children at the expense of the deceased spouse's children. If the bypass trust is designed in such a way that it satisfies the requirements of IRC section 2056(b)(7) and is eligible for the QTIP election, then it may be possible for the surviving spouse to deprive the deceased spouse's children of the benefit of the deceased spouse's AEA by making a QTIP election with respect to the bypass trust and making a Portability Election. In such a case, upon the death of the surviving spouse, the bypass trust (which has been QTIPed) will be included in the surviving spouse's gross estate, and may be required to reimburse the surviving spouse's estate for estate taxes attributable to the inclusion of its assets in the surviving spouse's gross estate.[43] As a result, the remainder beneficiaries of the bypass trust would bear estate tax on all assets passing to them while the surviving spouse's children would enjoy the benefit of both the deceased spouse's DSUE Amount and the surviving spouse's BEA. The tax reimbursement provisions of IRC section 2207A would cause the QTIP trust to bear tax first, which would deprive it of the benefit of the deceased spouse's AEA that would have otherwise been applied to the bypass trust assets. The remainder beneficiaries of the bypass trust might be able to argue that the QTIP election with respect to the bypass trust should be disregarded pursuant to Revenue Procedure 2001-38, which provides that a QTIP election will not be respected if it is not necessary to reduce the estate tax liability. Unfortunately, the remainder beneficiaries may lack standing to assert such a position and Revenue Procedure 2001-38 may not be enforceable in this context. To avoid this situation, the decedent's Will or revocable trust could contain a specific direction to the executor not to make a QTIP election with respect to the bypass trust, or the decedent could design the trust so that it will not qualify as a QTIP trust.

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[42] 2001-11 CB 1335.

[43] See IRC section 2207A.

F. Clayton QTIP Trust

Planners may wish to consider using a *Clayton* QTIP trust, rather than a traditional QTIP trust, for additional flexibility. With a *Clayton* QTIP trust, the surviving spouse's income interest in a QTIP trust is contingent upon the fiduciary's election to treat the marital trust property as QTIP property under IRC section 2056(b)(7).[44] The property elected for QTIP treatment remains in the QTIP trust, while the non-elected portion is distributed instead to a non-QTIP trust for the surviving spouse or to the deceased spouse's descendants, either outright or in further trust. To avoid an argument that the shift of income interest is a gift by the surviving spouse, the surviving spouse should not be the fiduciary making the QTIP election. The *Clayton* QTIP trust has the same advantages as the disclaimer and the partial QTIP, in that decisions about the extent to which a bypass trust should be funded are made after the deceased spouse's death. In fact, if the estate tax return is properly extended, the final decision about funding the bypass trust and using some, if not all, of the deceased spouse's AEA can be deferred for 15 months from the date of the deceased spouse's death (an extra 6 months after a disclaimer decision must be made[45]).

VII. PORTABILITY AND FIDUCIARY DUTY

A. Conflicts of Interest Created by Portability

The executor of the deceased spouse's estate holds the power to file a Form 706 and make the Portability Election. Preparing a Form 706 when one would not otherwise be required, however, necessarily creates an expense for the deceased spouse's estate. If the surviving spouse is the only beneficiary of the deceased spouse's estate, then that expense would be borne by the person who benefits from the Portability Election. However, if the expenses of administration are to be borne by beneficiaries other than the surviving spouse, a conflict of interest arises between the surviving spouse and the other beneficiaries. Consider the following situation:

> *Example 7*: Husband dies in 2015 with separate property of \$3,000,000. Husband's estate plan provides that Wife is to receive 50% of the estate and Husband's children from a prior marriage are to receive the other 50% of the estate. There is no community property. Husband's estate plan further provides that his children's share of the residue bears all expenses of administration in order to avoid the possibility of an interrelated computation relating to the marital deduction. Son, who is a residuary beneficiary, is the executor of Husband's estate. Wife has a troubled relationship with all of Husband's children, including Son, and none of the children are interested in depleting their inheritance in order to have Attorney prepare a Form 706

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[44] *Estate of Clayton v. Commr.* (CA 5, 1992) 976 F2d 1486; Treas. Regs. section 20.2056(b)-7(d)(3).

[45] IRC section 2518.

that is not required by law so that Wife can receive husband's $2,430,000 DSUE Amount. Wife has a separate property estate of $7,000,000, so she considers Husband's DSUE Amount to be a very valuable asset. Husband's estate plan documents contain no clear direction regarding the DSUE Amount.

B. Who is an Executor?

IRC section 2203 states that an executor for estate tax purposes is an "executor or administrator" of the decedent. If there is no "executor or administrator" appointed and acting, then "any person in actual or constructive possession of any property of the decedent" is an executor. In Example 7, if Son is the duly-appointed executor or administrator of Husband's estate, then Wife has no authority to file a Form 706 in order to make the Portability Election. However, if Son is merely the trustee of Husband's revocable living trust, and Wife received assets directly from Husband (such as from a joint tenancy account), then Wife has independent authority to file a Form 706 and make the Portability Election.

C. Fiduciary Duties

State laws impose on both executors and trustees duties of loyalty and impartiality with respect to beneficiaries.[46] When beneficiaries have conflicting interests with respect to the Portability Election, fiduciaries are faced with a difficult problem. In Example 7, if Son does not file a Form 706, he is harming Wife because she will not receive husband's DSUE Amount. If he files the return, he is harming the residuary beneficiaries since the residue bears all expenses of administration, including the attorneys' fees to prepare the return.

D. Possible Resolutions

1. Agreement Among Beneficiaries

The most efficient solution (aside from having the deceased spouse leave instructions in his or her estate plan) would be for the beneficiaries to agree upon whether a Form 706 will be filed and upon who will pay for the cost to prepare it. Any such agreement should be accompanied by the appropriate written consents and releases from the beneficiaries.

2. Court Instructions

If an agreement among the beneficiaries is not possible, the fiduciary may have no choice but to seek instructions from the court. Since the Portability Election must be made on a timely-filed Form 706, and a contested Petition for Instructions could take over a year to be litigated, practitioners must spot these issues early in the administration so they can be resolved timely.

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[46] See, e.g., Prob. Code, sections 16002 and 16003.

VIII. PLANNING AND DRAFTING CONSIDERATIONS

A. The ABCs of Estate Planning have Changed

1. Before Portability

Before portability, the choice of trust structure was rather simple. Assuming no marital property protection issues, the choice of trust structure would ordinarily be a function of the size of the combined marital estate.

a. *Disclaimer Trust* – A disclaimer trust plan provides that the entire estate passes to the surviving spouse upon the death of the deceased spouse but gives the surviving spouse the option to disclaim assets in order to create a bypass trust. If the combined marital estate was less than the AEA for a single spouse, a disclaimer trust plan was usually recommended.

b. *Bypass Trust with no QTIP Trust (an "AB Plan")* – This plan provides that the deceased spouse's assets are divided into two shares, with assets equal to the AEA passing to a bypass trust and the balance of the assets passing to the surviving spouse in order to qualify for the marital deduction. This was a common way to eliminate estate tax on the death of the deceased spouse while using the AEA of the deceased spouse. If the combined marital estate was greater than a single spouse's AEA but less than the combined AEAs of both spouses, an AB Plan was usually recommended.

c. *Bypass Trust with QTIP Trust (an "ABC Plan")* – This plan also provides that the deceased spouse's assets are divided into two shares, with assets equal to the AEA passing to a bypass trust and the balance of the assets passing to a QTIP Trust for the benefit of the surviving spouse in order to qualify for the marital deduction. This plan accomplished the dual goals of using the AEA of the deceased spouse while protecting the deceased spouse's assets from creditors of the surviving spouse as well as dispositions not anticipated by the deceased spouse. If the combined marital estate was greater than the combined AEAs of both spouses, an ABC Plan was usually recommended.

2. After Portability

a. *No Affirmative Estate Tax Planning* – With portability, there is no need to do any affirmative estate tax planning

for smaller estates, particularly those with combined estates well under the AEA.

b. *Disclaimer Trust* – While affirmative estate tax planning may not be required with smaller estates, it may be advisable to include the option to create a bypass trust by disclaimer for creditor purposes, to guard against possible future changes in the law, or to give the surviving spouse the option to create a bypass trust if desired.

c. *AB Plans* – AB Plans are still useful, but in a slightly different context that before. If the combined marital estate is less than a single spouse's AEA, the sole purpose of an AB plan is to implement marital property protection planning. For larger estates, it provides the additional benefit of giving the surviving spouse the option to use bypass planning in order to grow the bypass amount after death or to implement GST planning.

d. *ABC Plans*. – For larger estates, an ABC plan continues to make sense, particularly with assets that are not likely to be sold or depreciated after the death of the surviving spouse. It is also appropriate to implement GST planning.

3. Making Bypass Trust QTIPable

Regardless of which structure is used, it is important to give the trustee or executor, as the case may be, the option to QTIP the bypass trust.

4. State Death Tax Considerations

Various states have uncoupled estate taxes that may require separate planning. For example, Washington's estate tax provides a $2,000,000 exemption tied to inflation with no portability. In such states, affirmative state estate tax planning using one of the above-referenced structures will still be required.

B. Directing the Treatment of the DSUE Amount in Estate Plan Documents

The DSUE Amount is an important asset to any surviving spouse. As such, the estate plan should treat it as an asset and specifically direct its disposition. If one intends to have his or her DSUE Amount ported to a surviving spouse, the estate plan documents should expressly require the deceased spouse's executor to file a Form 706, even if one is not required, in order to make the Portability Election. If one would rather leave the decision to the discretion of the executor, the estate plan documents should exonerate the executor from liability for making or not making the election. Furthermore, the estate plan documents should expressly direct how the expenses for preparing the Form 706 are to be paid.

C. Premarital Agreements

In the context of a premarital agreement, it may be wise for each spouse to include provisions in the agreement that require each spouse to direct his or her trustee or executor to make the Portability Election in order to port the DSUE Amount to the surviving spouse.

D. Structuring the Bypass Trust to Qualify for QTIP Treatment

As discussed previously, it may be preferable in some cases to use a traditional QTIP trust in conjunction with portability, or a *Clayton* QTIP trust-bypass trust-portability combination, rather than a traditional bypass trust to use the deceased spouse's AEA. However, it is possible that the preferred course of action may not be apparent until after the death of the deceased spouse. In order to leave the flexibility to use either alternative, it may be wise in appropriate cases to design the terms of the trust that is to receive the deceased spouse's assets in a manner that allows it to qualify for QTIP treatment. By doing so, the executor can decide after the deceased spouse dies whether to make a QTIP election, and the extent to which such election should be made, in light of the facts and circumstances at that time. This is particularly true in light of the uncertainty caused by Revenue Procedure 2001-38.

E. Order of Death Presumption

When spouses have unequal assets, it has been common practice to draft estate plan documents to provide that, in the case of simultaneous deaths, the wealthier spouse is presumed to die before the less wealthy spouse. When the AEA was lower, doing so allowed the bypass trust to be more fully funded and created the opportunity to use the surviving spouse's AEA to shelter a portion of the deceased spouse's assets that exceeded his or her AEA. With the increased AEA and portability, however, creating the presumption that the wealthier spouse dies first could cause a net reduction in the amount of AEA available to the surviving spouse, particularly for a spouse who has an existing DSUE Amount from a prior spouse.

> *Example 8*: Husband and Wife 1 have been married for 30 years and have children together. They have a joint estate of $8,000,000 and decide to rely solely on portability to shelter their assets from estate tax. In 2011, Wife 1 dies and leaves all of her assets to Husband. Consequently, Wife 1's entire $5,000,000 DSUE Amount is ported to Husband. In 2012, Husband marries Wife 2. Wife 2 has children from a prior marriage and $3,000,000 of separate property. They each prepare estate plans that leave their assets to their respective children regardless of the order in which they die. In late 2012, they die in a common accident. If Husband is presumed to predecease Wife 2, his AEA would be $10,120,000, consisting of his 2012 BEA of $5,120,000 and Wife 1's 2011 DSUE Amount of

$5,000,000. Consequently, his children would bear no estate tax. If, however, Wife 2 is presumed to predecease Husband, then her estate would use $3,000,000 of her AEA and would port $2,120,00 of DSUE Amount to Husband. Since Husband can use only the DSUE Amount of the last deceased spouse (Wife 2, in this case), his AEA is effectively reduced from $10,120,000 to $7,240,000, consisting of his 2012 BEA of $5,120,000 and Wife 2's DSUE Amount of $2,120,000. As a result, upon his death, estate tax of $266,000 would be due because of the order of death.

IX. CONCLUSION

While it is tempting to think of portability as simply a post-death administrative concept, portability has a significant impact on the majority of estate plans created for married clients. Portability offers married clients another planning option and, depending upon the clients' particular situation, may provide them with additional flexibility in their estate plan. However, portability also creates a multitude of pitfalls and new complexities, and places a greater burden on estate planners to provide for the appropriate use of portability and to draft the necessary flexibility into estate plans, so that a surviving spouse or other heirs of a deceased spouse can elect to use portability in a manner consistent with the deceased spouse's intent. It also raises lifetime gift planning issues, where a spouse has DSUE Amount of a prior spouse that is likely to be greater than any DSUE Amount he or she may receive from a subsequent spouse. Estate planners must give careful thought to portability issues with each set of married clients, as the appropriate advice will vary depending on the clients' circumstances.

TAX AND ESTATE PLANNING ISSUES FOR U.S. CLIENTS WHO OWN FOREIGN PROPERTY

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Tax and Estate Planning Issues for U.S. Clients Who Own Foreign Property

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I. Introduction

A. When a U.S. citizen or resident client owns property in a foreign country, that client will face a number of U.S. and foreign legal and tax issues, and these issues sometimes are complicated or simplified by treaties between the United States and the foreign country involved.

B. The most obvious situation is when a U.S. client owns real property in another country. Numerous complex issues, however, can also arise when the client owns intangible property with a connection to another country, such as shares in a foreign corporation or an interest in a foreign partnership. While these items of property may not raise too many foreign succession law issues, these items of property can raise complex federal income tax issues for clients. In all cases, U.S. federal estate tax issues will also be lurking.

C. This outline describes some of the basic ground rules that U.S. estate planning advisers should follow when U.S. citizen and resident clients own foreign property, with a focus on succession law issues, federal income tax issues, and federal estate tax issues.

II. Some Basic Things You Should Know About Foreign Succession Law and Tax Law

A. *Not Every Country Works Like The United States*

1. Apart from Louisiana, all U.S. states have the common law legal system, which originated in England centuries ago. Louisiana has a mixed system of common law and civil law, which it inherited from the French. Puerto

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Rico also has a civil law legal system. Some of the U.S. states that were part of Mexico retain an important feature of the civil law – community property.

2. The United States shares the common law system with other jurisdictions that inherited their legal system from England, including the Canadian provinces and territories (other than Quebec), the Australian states and territories, Ireland, and New Zealand. While the language of common law countries is usually English and the legal systems in these jurisdictions are similar, the differences in substantive law among the jurisdictions means that a U.S. lawyer cannot assume that the law in England, for example, is the same as the law of Illinois.

3. The other major legal system that you are likely to encounter when you have clients with foreign property is the civil law system.

   a. The civil law system derives from Roman law and the Corpus Juris Civilis of the Emperor Justinian. Most of the civil law countries have taken the path of enacting codes of law that reflect general legal principles. A few jurisdictions, however, such as Scotland, have implemented the Roman tradition without a code.

   b. Those civil law countries that rely on codes enacted by legislatures were generally inspired by the Napoleonic Code that France implemented following the French revolution. The laws in Spain, Italy, the Netherlands, Portugal, and many Latin American countries were heavily influenced by the Napoleonic Code. The Napoleonic Code also influenced the development of the German Civil Code, although the German Civil Code is more precise and technical than the Napoleonic Code. Japan has adopted the German Civil Code. Switzerland also developed its own Civil Code in the early 1900s, and the Swiss Code, along with the French and German Codes, influenced the Brazilian, Peruvian, and Mexican codes. *See generally* Tetley, "Mixed Jurisdictions: Common Law vs. Civil Law (Codified and Uncodified)" at 6-7 (1999) (available online at www.unidroit.org/english/publications/review/articles/1999-3.htm).

   c. The principal difference between a civil law system and a common law system is the role of courts. In a common law jurisdiction, judicial decisions are the principal source of law; statutes supplement the common law. Court decisions in common law jurisdictions have the force of law through the principle of stare decisis. On the other hand, in civil law countries the codes or the uncodified general principles of law are the principal source of the law. Court decisions that interpret the law do not have preferential effect. Although court decisions may be looked to by civil law

lawyers as evidence of what the law is, the opinions of commentators sometimes are as important as court decisions in interpreting the law. *See generally* Hansman & Mattei, "The Functions of Trust Law: A Comparative Legal and Economic Analysis," 73 N.Y.U.L. Rev. 434, 439-442 (pointing out that "academic lawyers in the universities were the leading force in development of the law" and that "[t]he law itself was to be found not in a register of [civil] writs, but in the Justinian compilation….").

d. Civil law systems also differ considerably from common law legal systems in their substantive law, particularly in the area of succession law and property law, which is of great interest to estate planning advisers. The principal differences between the legal systems with respect to matters of succession law are discussed below. If you remember nothing else about a civil law system, however, remember that trusts are not a part of civil law legal systems.

4. Countries with a predominantly Islamic population are likely to follow the general traditions of Sharia law, the jurisprudence of which is based on the Koran and other important Islamic religious sources. There is considerable variety among the Islamic countries with respect to their substantive rules, making it hard to generalize about those rules. In general, however, the Sharia legal system shares more in common with civil law countries than with common law countries, particularly with respect to matters of succession law.

5. The legal systems in a number of jurisdictions have elements of both civil law and common law, including Scotland, South Africa, Quebec, Puerto Rico, the Philippines, and Louisiana.

B. *Succession Law Is Not The Same In The Rest Of The World*

1. A fundamental feature of any legal system is rules related to property ownership, and an important subset of these rules is the rules related to transfers and inheritance of property on death. This outline refers to these laws as "succession laws."

2. Common law jurisdictions generally allow an individual to give his or her property to whomever he or she wishes in the form that he or she wishes, including in trust. Spousal elective share laws and community property laws sometimes limit an individual's ability to freely dispose of all his or her property; these laws vary widely from jurisdiction to jurisdiction. State statutes in the United States generally allow after-born children to take their intestate share of a decedent's estate under pretermitted heir statutes.

3. Civil law countries, on the other hand, traditionally limit an individual's testamentary freedom through community property laws and forced heirship laws.

   a. Many civil law countries follow a default system of community property for property acquired by a couple while married, which limits one spouse's ability to disinherit the other spouse. Lawyers in the United States should be familiar with the general principles of Spanish and French community property law given the influence of those laws on the U.S. community property states. Other civil law jurisdictions have different systems that tend to have similar results. German law, for example, has three kinds of marital property regimes. The default marital property regime is *Zugewinngemeinschaft* or "community of surplus." This regime is not a classic community property regime the way that U.S. lawyers understand community property. The other regimes are community property (*Gütergemeinschaft*) and separate property (*Gütertrennung*). If a couple who was married in Germany wanted one of the optional regimes to apply during their marriage they would have had to have a notary draw up a fairly simple agreement to that effect.

   b. Civil law countries' "forced heirship" laws also limit an individual's ability to freely dispose of his or her separate property and his or her share of community property.

      (i) Forced heirship laws either in actuality or in effect require a decedent to leave some proportion of his or her assets to his or her children at his or her death. Forced heirship laws also may give a surviving spouse a share of a decedent's estate in addition to the share to which a spouse may be entitled under the country's marital property laws.

      (ii) For example, Italian forced heirship laws apply to a decedent's one-half share of community property and the decedent's separate property. If there is a surviving spouse and one child, the spouse's "compulsory share" or *riserva a favore dei legittimari* is one-third of the subject property; the child's compulsory share is also one-third of the subject property. If there is a surviving spouse and more than one child, the spouse's compulsory share is one-fourth. If there is no spouse and one child, the child's compulsory is one-half of the subject property. If there is more than one child, the children's collective compulsory share is two-thirds of the property. Children of deceased children succeed to the rights of their deceased parents.

(iii) German forced heirship laws take a slightly different approach than the Italian forced heirship laws. Germany's forced heirship laws give a disinherited heir a monetary claim against the persons who received the decedent's estate. Thus, a German individual can dispose of his or her estate as he wishes but the persons to whom he or she leaves his or her property may face a monetary claim from the disinherited children and the decedent's surviving spouse. The amount of a disinherited heir's claim (*Pflichtteil*) is equal to one-half of the value of the share that the heir would have received had the decedent died intestate. The intestate shares of descendants and a spouse vary under German law. Germany includes gifts made within 10 years of death in the pool of assets used to determine the value of a forced heirship claim.

(iv) Swiss law similarly treats forced heirship claims as monetary claims against the individuals or entities who receive a decedent's property. Like the laws in many other civil law countries, Swiss law pulls gifts within five years of death back into the estate for purposes of computing the basis on which a forced heirship claim could be made. Swiss law also pulls back a gift made more than five years before death if the purpose of the gift was to avoid forced heirship laws.

4. What are the implications of forced heirship laws for estate planning?

a. Forced heirship and community property laws leave very little of an estate for an individual to dispose of. As a result, individuals who live in civil law countries tend not to use wills to the same extent as individuals who live in common law countries do. When individuals in civil law countries use wills, those wills are often not as extensive or complicated as wills used in common law countries. Part of the reason for this is the absence of trusts as part of the law in most civil law countries.

b. Estate and inheritance tax systems in civil law countries often complement the country's forced heirship laws. Thus, gifts to close relatives, which forced heirship law requires, are taxed at a lower rate than gifts to more remote relatives. In some civil law countries, a gift or bequest to a trust is treated as a gift to an unrelated person that attracts inheritance tax at the highest rate.

c. While not necessarily tied to forced heirship laws, you should be aware that notaries, rather than lawyers, often draft wills and related documents in civil law countries. A notary in a civil law

country is not like a notary public in a common law country. Rather, the civil law notary is a legal professional who drafts legal documents such as conveyancing, contracts, and wills. By contrast, a notary public in the United States simply has the power to take oaths from witnesses and acknowledge legal documents.

C. *Trusts Are Not Used Everywhere In The World*

1. The trust is among the most useful and flexible devices in the U.S. estate planner's play book. Trusts, however, are not found everywhere in the world. Believe it or not, much of the world manages to do estate planning without trusts. *See* Langbein, "The Contractarian Basis of the Law of Trusts," 105 Yale L.J. 625, 669 ("[W]hen we ask how the Europeans function without the trust, we find that they achieve mostly by means of contract what Anglo-American systems do through trust."). Thus, it is important to understand that when you start thinking about a client's foreign property, you may not be able to use a trust.

2. Trusts are generally seen as a creation of English court of chancery, which later merged with the law courts in England. As England exported its law to other countries during its days of imperialism, many of those countries picked up the common law of trusts as part of the common. Trusts are now an established part of common law legal systems, including in many tax havens which have an English legal heritage.

3. Codes in civil law countries, on the other hand, do not normally contain trust laws. Civil law countries do have certain kinds of entities and relationships that resemble trusts, but these entities and relationships lack the bifurcation of ownership that is one of the essential elements of a trust. Some civil law countries such as Japan and South Africa do have trusts by statute, but they are isolated examples. Interestingly, at least one scholar's research suggests that the trusts do in fact have roots in the civil law. Lupoi, "The Civil Law Trust," 32 Vand. J. Transnat'l L. 967, 973 ("ample evidence exists that testamentary secret trusts were well known in Europe in the sixteenth and seventeenth century"). The French Revolution, however, ended the development of trust law in France and, therefore, throughout Europe and Latin America, given the influence of the Napoleonic Code on the law in those other jurisdictions.

4. Some civil law countries are signatories to the Hague Convention on the Law Applicable to Trusts and Their Recognition. This outline discusses the convention in more detail below. A country's accession or ratification of the convention, however, does not mean that the country adopts trust law as part of its domestic law. Rather, the convention simply requires a signatory to recognize a trust and certain features of a trust if the trust is valid under the law of a jurisdiction the domestic law of which provides for trusts.

5. Some civil law countries do recognize trusts as part of their domestic law. Colombia and Liechtenstein, for example, recognize and enforce trusts as part of their domestic law. Italy is also developing a domestic law of trusts based partly on the Hague Convention on the Law Applicable to Trusts and Their Recognition. *See* Lupoi, *supra*, at 985-988.

6. Civil law countries also have legal arrangements that achieve results similar to the result of a trust, though they are not identical to trusts. *See generally* Christensen, "Foreign Trusts and Alternative Vehicles," 12-16 (published by ALI-ABA in its International Trust and Estate Planning Course of Study Materials, August 2012).

   a. For example, a usufruct (*usufruit*) is a right to use property for a period of time, which can be measured by a life or by a term of years. The holder of the usufructuary interest has the right to the income from the property and the use of the property. Another person, the remainderman, in English legal terminology, has a "naked interest" or "*nue proprieté*." The principal difference between the usufruct and the trust is that there is no trustee.

   b. Switzerland and Liechtenstein provide by statute for a foundation or "*stiftung*," which has some features similar to a trust, such as a person holding property for the benefit of another. Germany and Austria recognize foundations for charitable purposes. The uses of foundations, however, are more limited than the use of trusts in common law legal systems. Christensen, *supra*, at 13.

7. The lack of trust law in civil law countries, even in ones that have adopted the Hague Convention on the Law Applicable to Trusts and Their Recognition, has several implications for U.S. estate planning advisers.

   a. The trust is not necessarily part of the estate planner's tool box for property in a civil law country, though, as discussed below, to some degree this turns on the country's choice of law rules.

   b. Even if a civil law country's choice of law rules appear to permit the use of a trust to hold property in that country, there may be practical difficulties in doing so. For example, it may be difficult to register land in the name of a trust in a country that does not recognize trusts and the distinction between legal and equitable ownership.

   c. If a client has property in a civil law country that he or she wants to pass to a trust, it may be advisable to hold the property through an intermediate entity, such as a corporation or other company, and have a trust in the United States or a tax haven own the shares or interests in the company.

d. Depending on the country's choice of law rules, a gift to a trust may give rise to claims by the donor's family members under forced heirship laws.

e. Because civil law countries do not have trusts, the tax treatment of trusts is often uncertain or rather onerous. As noted above, some countries treat gifts to trusts as gifts to unrelated persons, which triggers an inheritance tax at a higher rate. The income tax treatment of a trust in a civil law country can also be uncertain if the trust has income with a source in that country, such as rental income. A country may also want to ignore a trust for purposes of its wealth tax and treat the trust beneficiaries as if they own the trust property outright.

8. Even if your client has property in a common law jurisdiction, the trust law and related tax laws in that jurisdiction are likely to differ somewhat from trust law commonly found in the United States, making it trickier to use trusts in those jurisdictions.

a. There are many differences between the English common and statutory law of trusts and the common and statutory trust law of the U.S. states. For example, England follows the common law rule against perpetuities but provides that a trust with a term of 80 years or less will not violate the rule. Contrast this provision with the lack of a rule against perpetuities in many of the U.S. states or the 90-year rule under the Uniform Statutory Rule Against Perpetuities. Another difference is that it is much easier for the beneficiaries and trustees to vary an irrevocable trust under English law than it is under U.S. law.

b. The other common law countries usually follow the English common law of trusts and give English court decisions much more weight than U.S. decisions, if they even consider those decisions. Thus, much of the common law of trusts and statutory law of trusts in British Commonwealth jurisdictions has more in common with English law than U.S. law. The Canadian provinces, however, tend to follow U.S. developments a little more closely than other common law jurisdictions. For example, the Canadian version of the prudent investor rule was inspired in part by the U.S. prudent investor rule. *See* Uniform Law Conference of Canada Report, "Investment by Trustees: The Prudent Investor Rule Revisited" (1996) (available online at www.law.ualberta.ca/alri/ulc/96pro/e96n.htm). Furthermore, and with the internet and the ease of obtaining court decisions, there seems to be a greater incidence of courts and legislatures looking to U.S. court decisions and legislation with respect to trust related issues. Despite this apparent trend, you should not assume that the

laws of another common law jurisdiction are the same as they are in the United States

c. As discussed below in connection with U.K. inheritance tax treatment of gifts to trusts, the common law countries also may treat trusts considerably differently than the United States under those countries' wealth transfer tax laws.

d. The common law countries can also vary considerably in the way that their income taxes apply to trusts. In Canada, for example, the transfer of appreciated property to a trust, revocable or irrevocable is generally treated as a disposition of that property for Canadian federal capital gains tax purposes. There are certain exceptions to this deemed disposition rule for individuals over age 65 who transfer appreciated property to "alter ego" and "joint partner" trusts. Canada also deems a trust to have disposed of its property every 21 years for federal income tax purposes, which has an effect not unlike the U.S. federal generation skipping transfer tax.

D. *Taxation of Wealth Transfers Varies Considerably Among Countries*

1. Because a client has foreign property, you might assume that you will have a foreign gift tax or estate tax issue because of that property. While you may be right in your basic assumption, you should not assume that another country taxes transfers of wealth in a manner similar to the United States federal gift, estate, and generation-skipping tax.

2. Some countries have no wealth transfer taxes, such as Australia, Canada, Sweden, Israel, Mexico, and China. These countries, however, may have other kinds of taxes or tax policies that affect gifts and inheritances of property. Canada, for example, deems the death of a person to be a disposition of appreciated property for income tax purposes. Australia, on the other hand, permits deferral of capital gains through a carry over basis scheme.

3. Some countries have estate taxes but not gift taxes. Although the United Kingdom has an inheritance tax, the inheritance tax does not apply to gifts made more than seven years before the decedent's date of death. If the donor dies during the seven-year period after he or she makes a gift, however, some or all of the gift may be subject to inheritance tax. Despite the lack of a gift tax, a U.K. donor's gift to a trust may attract an immediate inheritance tax and may not be a "potentially exempt transfer." In this way the United Kingdom in fact has a gift tax, but only on gifts to discretionary trusts. The "gift tax" applies to amounts exceeding £325,000 (the "nil rate band"). The tax rate will initially be 20% on a transfer to a trust but could increase to 40% if the settlor dies within seven years of making the transfer. In addition to the immediate inheritance tax charge,

the trust will be subject to a charge every 10 years – the "ten-yearly charge" of up to 6%. A charge may also apply on large distributions from the trust.

4. Civil law countries usually have "inheritance" taxes.

   a. The civil law countries with wealth transfer taxes have either true inheritance tax systems or, as in some states of the United States, estate taxes that superficially resemble inheritance taxes.

   b. A true inheritance tax is based on the citizenship or residency of the recipient of the transferred property; the donor's citizenship is irrelevant. Thus, in countries with a true inheritance tax, a resident or citizen beneficiary is taxed on all property he or she receives, regardless of its location and regardless of the donor's citizenship. Spain and Japan take this approach. Germany also takes this approach, though it also bases its taxation on a decedent's residency in Germany or a decedent's ownership of property in Germany.

   c. Other civil law countries call their death taxes "inheritance taxes" because the rates and amounts of tax depend on the class of beneficiary receiving property. These countries, however, impose the tax based on the citizenship or residency of the decedent or on the location of the property, not of the recipient. To this extent, the tax is on transfers made by the decedent. A beneficiary is not taxed on the receipt of property from a nonresident or noncitizen decedent located in another country, except for property located in the taxing country. Countries that follow this approach include Belgium, Greece, Norway, and Germany. These taxes closely resemble U.S. state inheritance taxes.

   d. In civil law countries an inheritance tax often complements the countries' community property and forced heirship laws; the more remote the beneficiary, the higher the tax rate. German gift and inheritance tax law, for example, bases its gift tax and inheritance tax rates on the relationship of the donor to the donee. A descendant is a Class I beneficiary; the top marginal rate for gifts or bequests to such a beneficiary is 30% (above €26 million). The general view in Germany is that trust is a Class III beneficiary regardless of the identity of the trust beneficiaries. The top marginal rate on a gift or bequest to a Class III beneficiary is 50% (above €13 million). Thus, a gift by a German resident to a trust for U.S. beneficiaries can trigger considerable German gift taxes.

E. The collective impact of all these differences between U.S. tax law and foreign tax law and succession law suggests one thing: strongly consider using foreign

lawyers and tax advisers to help you when your clients have foreign property. Imagine a foreign lawyer trying to figure out how to dispose of property in one of the U.S. states, including attempting to understand the federal, state, and local tax consequences of the disposition. Do you want to try the same thing in a foreign country? You will sleep better if you seek foreign advice in one form or another during the estate planning process.

III. Should You Use a Situs Will?

A. The first question most lawyers and other advisers ask is whether a client should have a separate will for the client's foreign property. This part of the outline discusses that question and a client's options.

B. *What is a "Situs" Will?*

1. A "situs" will can take many forms, which can make such a will tricky to draft and to coordinate with the client's U.S. will.

2. One way to think of "situs" is to follow the common law tradition of distinguishing between immovable property and movable property. For example, an English situs will could dispose of only immovable property located in England, i.e. real property and improvements. The U.S. will would then dispose of all movable property whether located in England or in the United States. Such a will would be consistent with both U.S. and English choice of law rules.

3. A situs will could also define the property to which it applies based on the tax situs of the property. This might be appropriate where the client knows that the tax law of another country will apply to certain assets with a connection to that country. For example, a German situs will could cover German real estate and interests in German partnerships, both of which would be subject to German inheritance tax on a U.S. citizen's death under U.S. law and German law. Because Germany's inheritance tax applies in a manner very different from the U.S. federal estate tax, having a will that is designed to work effectively for German inheritance tax purposes may make sense. Of course, the client's estate will also owe U.S. federal estate tax on the property covered by the German will, which raises the possibility of the disposition in the German will doing more harm than good in the United States.

4. A situs will could also define its scope by reference to assets with a connection to the country without regard to whether those assets are movable or immovable. Such a will would be useful when a court or other official body in the other country would assert jurisdiction over assets with a connection to that country regardless of the domicile of the decedent. Professor Schoenblum points out that one risk of this kind of will is that the view of the other country as to the situs of the assets may differ from

the client's view of the situs of the assets, leading to potential confusion. 1 Schoenblum, Multistate and Multinational Estate Planning, § 16.16[C] at 16-86 (2009 ed.) ("Schoenblum").

C. *Advantages of Multiple Wills*

1. The main benefit of multiple wills is that they "eliminate the interrelationship of an estate's administration between jurisdictions." Lawrence, "Multinational Estate Planning Headaches and the Panacea Therefor," 1995 Inst. Est. Plan. ch. 18, § 1801.2 at 18-7 (1995).

2. With multiple wills, only one will needs to be presented for probate in the situs jurisdiction. Without a situs will, the decedent's U.S. executor will need to obtain a certified copy of exemplified of the client's will and have the will admitted to probate or registered in the foreign country, which could be an expensive and time consuming process. It may be faster and simpler to walk into court in a common law country and present a will for probate without worrying about what is going on in the United States. If the property is located in a country where English is not the official language, having the situs will in the local language can expedite the disposition of the client's property.

3. Another benefit of using multiple wills is that each will can be tailored to the substantive and conflicts rules for a particular jurisdiction. Schoenblum, § 16.16[C] at 16-85. These issues are discussed in greater detail below.

4. Multiple wills may also reduce fees and expenses in countries that compute fees based on worldwide assets. *Id.*

D. *Disadvantages of Multiple Wills*

1. Multiple wills are more expensive to prepare than a single will. Preparing multiple wills will involve two lawyers, one in the United States to prepare the U.S. will and another in the other country to prepare the other will. Both wills, of course, have to be coordinated, so the U.S. lawyer must talk to the foreign lawyer and work out the details.

2. Multiple wills also greatly increase the complexity of the estate plan. The lawyers responsible for the wills must make sure that the wills complement each other and are consistent with one another. Everything from tax clauses to revocation clauses need to be coordinated. If the non-U.S. will involves concepts unique to the foreign law, such as a usufruct in a civil law country, the coordination becomes trickier.

3. Another problem that can sometimes arise is that the two wills do not cover all the client's assets. For example, assume a U.S. will covers U.S. property and an English will covers property located in England. What if

the client has a bank account in the Isle of Man in his or her own name? That property would not be addressed by either will, resulting in an intestacy.

4. These issues and similar issues lead Professor Schoenblum to suggest that "multiple wills should rarely – if ever – be used." Schoenblum, § 16.16[C] at 16-87. He argues for the use of a revocable trust in lieu of multiple wills, which is discussed below. He acknowledges, however, that trusts will not always work, in which case "multiple wills, if constructed carefully, may offer certain benefits."

E. *How Do You Decide?*

1. While it is nice to know that there are advantages and disadvantages of having multiple wills, how do you advise a client on this subject?

2. These facts suggest using multiple wills:

   a. When the client has substantial real property or other investments in privately owned companies in a foreign jurisdiction. The more substantial the property, the more permanent the client's investment is likely to be. In this case, the client's ownership of the foreign property will present legal and tax issues apart from succession law issues. In this case, it usually makes sense for the client to have a situs will.

   b. Situations in which it is very difficult to conduct what U.S. lawyers think of as "ancillary" administration.

   c. Where the country has not adopted the Hague Convention Relating to the Form of Testamentary Dispositions or the Washington Convention, thereby raising issues of proof of the formal validity of a U.S. will. In this case it may make more sense to execute a will in the local language and in compliance with the local formalities.

   d. When you have no option but to probate the will or register the will in order to transfer title to property.

   e. If you expect disputes about the disposition of property in the other country. In this case, you can have a will tailored to address some of the issues that will come up in the other jurisdiction.

   f. If you want to do something complicated in the other country.

3. These facts suggest using a U.S. will to dispose of property located in a foreign country:

a. When the investment in the other country is not substantial or is not expected to be permanent. For example, a client may have inherited property located in a foreign country but expects to sell it.

b. When estate administration or registration of the property is fairly easy. In most common law countries, probate is not the onerous process that it is in the United States. Interestingly, in England and Wales, an estate normally must first file an inheritance tax return with Inland Revenue before obtaining a grant of probate.

c. Situations in which the disposition of the asset will be simple and in which issues of rules of substantive validity will not come into play.

d. The country has adopted the Hague Convention on Formal Validity or the Washington Convention. In this situation the will should at least be formally valid, though, as discussed below, the provisions of the will may be substantively invalid in the other country.

e. When the property is located in a common law country, such as England. In this situation the basic principles of succession law in that country will be similar to the laws of the United States, including testamentary freedom and the use of trusts. On the other hand, because a common law country will use its own law in determining the substantive validity of the provisions of the U.S. will, a specific gift of the foreign property in a manner that comports with local law may be appropriate.

f. When it will not be necessary to probate or register a will to transfer title to the property in question. For example, it may not be necessary to probate a will to transfer title to shares of a closely held company. In lieu of a probate, the company may be willing to simply transfer the shares on the books of the company. If this is the case, it may be easiest to make a specific gift of the shares in the U.S. will.

F. *Issues in Drafting the Client's U.S. Will*

1. If you decide that a client needs a foreign situs will and a U.S. will, you will presumably have a lawyer or notary in the other country prepare the situs will. You, however, will be drafting the U.S. will and related estate planning documents. In doing so you will need to be attentive to a number of issues, given that the will you draft will not cover all of the client's worldwide property.

2. The U.S. will must clearly state its scope, i.e. that it applies to all of the decedent's assets other than those covered by the foreign will. You should

make sure that the description of property covered in both wills is consistent.

3. Lawyers in the United States usually include a provision in a will that provides that the will revokes all prior wills and codicils. You do not want to include such a broad provision in the client's will because you do not want to revoke the client's situs will if he or she has already signed it. This will also be an issue for when you redo the client's U.S. will; you do not want to accidentally revoke the foreign will. The foreign will should have provisions that make it quite clear how to revoke the will so as to avoid any accidental revocation by a subsequent U.S. will or codicil to that will.

4. The drafting lawyer must also carefully consider the tax apportionment and payment clause in the U.S. will. If the client has foreign property, his or her estate may be responsible for foreign death taxes as well as federal estate tax. The drafting lawyer and the client should consider who should pay the foreign taxes and U.S. taxes on the property and coordinate tax payment provisions in the U.S. will and the foreign will. Opting for full apportionment of all death taxes, foreign or U.S., in the decedent's U.S. will be appropriate when you cannot predict what those taxes will be. On the other hand, it may make sense to pay U.S. death taxes on the foreign property from the client's U.S. estate. You should be skeptical, however, of a clause in the U.S. will that requires the residue of the decedent's estate to pay all death taxes, foreign or U.S. You should also consider whether and how to apportion the benefit of any credit against the U.S. federal estate tax for any foreign death taxes that the estate may pay.

G. *Other Ways to Transfer Foreign Property*

1. A will is not the only way to dispose of property on death. In fact, U.S. lawyers are quite familiar with ways to transfer assets other than by will. Sometimes these well-known techniques will work for foreign property. In other situations there may be options that you would not necessarily think of.

2. One question to ask is whether your client needs a will to cover property physically located in a civil law country. In civil law countries, property vests in a decedent's heirs immediately on the decedent's death; there is no intervening change of title to an executor as there is in a common law country. If the client would leave the property in his or her will in the exact same manner as would occur under the succession laws of the civil law country, a will might not even be necessary. Simply allowing the property to vest in the decedent's heirs may make more sense, particularly if the heirs are likely to sell the property. This approach makes for a much cleaner record. In fact, a client's U.S. will in some of these countries might have limited applicability due to the country's community property

and forced heirship rules, although the answer to this question depends on the country's choice of law rules. If you use this approach, you need to carefully draft the U.S. will to exclude the foreign property. This assumes that the country in question would apply its own intestacy rules on the death of the decedent. As discussed below, it is possible that the country might apply the law of the U.S. state of the decedent's domicile to determine the intestate takers under the will. This strategy would not be appropriate for a common law country.

3. If the client owns property in a common law jurisdiction, the client could put the title in joint names with other persons. Joint ownership with rights of survivorship is generally recognized in common law countries and it is just as easy in those countries to transfer title on death by survivorship as it is in the United States. Joint ownership between spouses is particularly useful in England because of the similarity of forms of title to the United States and the fact that as long as the domiciles of the husband and wife are the same, U.K. inheritance tax will not apply until the death of the surviving spouse.

4. On the other hand, a revocable trust is not usually a reliable way to make a transfer of property in another country, even a common law country.

    a. An attempt to transfer real property located in a civil law country presents obvious issues given the lack of trusts as part of the civil law. In this situation, it may be possible for the client to transfer the real property to a corporation or other vehicle and transfer the shares to a revocable trust. This combination of steps would permit an effective transfer of the property on the client's death without a probate or other registration issues. Such a strategy, however, usually raises tax issues in the other country, including stamp or real estate transfer tax or a deemed disposition for capital gain tax purposes. Furthermore, unless the client uses a foreign entity that is eligible for a check the box election, the corporation he or she uses will likely be a controlled foreign corporation for U.S. income tax purposes, which at a minimum trigger extra tax compliance obligations for the client.

    b. Even in common law countries a revocable trust usually is not a desirable way to transfer property on the death of a nonresident of that country.

        (i) The use of a revocable trust as a will substitute is much more common in the United States than in other common law countries. The use of revocable trusts and pour over wills is made possible by the testamentary additions to trusts acts in the U.S. states. Without such a statute, a pour-over gift in a will might not be valid under the

incorporation by references rules in the common law of wills. For example, the provinces and territories of Canada other than the Yukon Territory do not have testamentary additions to trusts acts, making the effect of a pour-over from a will to a revocable trust uncertain. *See* Yukon Wills Act §§ 27 – 29 (R.S.Y. 2002, c. 230).

(ii) Even if you wanted to use a fully funded revocable trust as a probate avoidance device in a common law country, its use may raise income tax issues. In Australia, for example, the transfer of real estate to a revocable trust attracts real estate transfer tax and may be a deemed disposition of the property for capital gains tax purposes. Similarly, a U.S. citizen or resident's transfer of Canadian real property to a revocable trust will be deemed disposition of that property for Canadian income tax purposes. The "alter ego" trust and "joint partner" trust, the use of which can defer Canadian income tax until the death of the settlor or the settlor and the settlor's spouse, are limited to residents of Canada who are 65 years of age or older.

(iii) Even though tax havens often permit the use of revocable trusts, the transfer of local real estate to such a trust may attract a stamp duty or similar excise tax. Revocable trusts under the law of those jurisdictions are more useful for company shares and other intangibles that can easily be titled in the name of the trust.

5. It may be possible to transfer certain assets by beneficiary designation in various countries. For example, a death benefit payable under a life insurance policy issued by a U.K. life insurance company could pass by beneficiary designation. Similarly, a former Canadian resident who now lives in the United States can designate a beneficiary for an interest he or she may still have in a registered retirement savings plan or "RRSP."

IV. Is a Client's U.S. Will Formally Valid in Another Country?

A. *Introduction*

1. When you venture into advising your client about how to dispose of his or her foreign property on his or her death, the legal system of your state will encounter another legal system – the system of the jurisdiction in which the client owns property. That system may be a common law legal system, such as England or Canada, a civil law legal system, such as France or Japan, or a Sharia (Islamic) law system.

2. Private international law or, as U.S. lawyers refer to it, conflicts of law rules, will help navigate you through such a meeting of the legal systems. When the common law system in which you practice meets the other legal system, there may be a seamless transition or there may be a collision. Private international law should help you sort out the choice of law issues.

3. This section of the outline addresses the issues that are likely to arise when a U.S. client dies owning property in that country.

B. *Formal Validity*

1. The first issue to consider is whether another jurisdiction will consider your client's will to have been validly executed. This is an issue familiar to lawyers who practice in the United States because each state has similar, but not identical, requirements for the execution of a will and how to prove the due execution of the will in a probate proceeding.

2. If a will is formally invalid, a U.S. court will not allow the will to be probated. On the other hand, even if a will is formally valid does not mean that the will will be probated. For example, the testator may have revoked a properly executed will. In addition, the will might be invalid because it was procured by fraud or undue influence. Other substantive laws might make a will wholly or partially invalid. To this extent, formal validity involves a rather narrow inquiry.

3. In jurisdictions other than the United States a will must be formally valid before that jurisdiction's laws will give the will effect, all other things being equal. Thus, in order for any will to effectively dispose of property within the jurisdiction of a state or country other than the testator's state of domicile, that will must be formally valid under that state or country's law.

4. Fortunately, difficult questions of private international law can often be avoided in this area because of two multilateral conventions: The Convention Providing a Uniform Law on the Form of an International Will and the Hague Convention Relating to the Form of Testamentary Dispositions.

C. *Convention Providing a Uniform Law on the Form of an International Will (the "Washington Convention")*

1. Introduction

a. For many years the formal validity of a will depended on choice of law rules in the country in which the will was sought to be given effect. Due to the difference in choice of law rules among countries, this approach led to uncertainty as to whether wills

executed in one state or country were valid in another state or country.

b. To resolve this problem, a number of countries adopted the Washington Convention, which provides for the automatic recognition of the formal validity of an "international will." Unlike many multilateral treaties, the signatories to the Washington Convention agreed to adopt as domestic law a series of uniform laws related to the recognition of the formal validity of an international will. The signatories' intent was to make the recognition of the formal validity of an international will a matter of domestic substantive law rather than a matter of private international law.

c. The Washington Convention has entered into force in the following countries:

> Belgium, Bosnia-Herzegovina, Canada, Cyprus, Ecuador, France, Italy, Libya, Niger, Portugal, Slovenia.

There are also a number of countries that have signed the treaty but in which the treaty has not been ratified or entered into force:

> Holy See, Iran, Laos, Russian Federation, Sierra Leone, United Kingdom.

d. The United States is an original signatory of the Washington Convention. Because of the federal character of the United States, the states had to enact the uniform legislation one by one; many of them have adopted the Uniform International Wills Act, either as stand-alone legislation or as part of the Uniform Probate Code. *See generally* 8 Unif. Laws. Ann. at 243-253 (1998 and 2005 Supp.) (Alaska, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Dakota, Oregon, Pennsylvania, South Carolina, South Dakota, U.S. Virgin Islands, Utah, Virginia, Vermont, Wisconsin). Many of the Canadian provinces and territories have also adopted legislation implementing the Washington Convention.

e. The benefit to a U.S. client of the Washington Convention is that when the client executes an international will, the client can be sure that the will is formally valid in a country that is a signatory to the convention. The assurance comes from the fact that the other state or country will have adopted as part of its domestic law a

choice of law rule that recognizes the formal validity of an international will.

2. Requirements of an International Will

a. Requirements as to form (Annex to Convention, Articles 3-7).

(i) The will must be in any form of writing, including typewritten and handwritten, and may be in any language.

(ii) The testator must declare in the presence of two witnesses and a person "authorized to act in connection with an international will" that the will is the testator's will and that he or she knows the contents of the will.

(iii) The testator must sign the will in the presence of the witnesses and the authorized person or, if the testator has already signed it, acknowledge his signature to the witnesses and the authorized person.

(iv) The witnesses and the authorized person must "there and then" attest to the will by signing it in the presence of the testator.

(v) All signatures must be at the end of the will. If the will has more than one page, the testator must sign each page. Each page must be numbered.

(vi) The date of the will must be "noted" at the end of the will by an "authorized person."

b. Certificate

(i) The authorized person must attach a certificate to the end of the will that provides that the procedures for the execution of an international will have been complied with. Annex to Convention, Article 9.

(ii) The uniform legislation provides a sample form for the certificate.

(iii) In the absence of evidence to the contrary, the certificate serves as proof of due execution of the will and its formal validity. Annex to Convention, Article 12.

(iv) A self proving affidavit is not required. The use of the certificate to prove due execution derives from the practice in civil law countries of executing wills in front

of a notary. The lack of a further requirement to prove due execution is also consistent with the rather simple approach to admitting a will to probate in most common law jurisdictions by the presentment of a will. By contrast, the U.S. states have much more rigorous procedures for probating a will, such as proof of the will's due execution by the witnesses. *See* Comment to § 5 of the Uniform International Wills Act, 8 Unif. Laws Ann. at 261 (1998).

c. Who is an authorized person?

(i) The enabling legislation for the Washington Convention requires an authorized person to be present at the execution of the will, to sign the will, and to complete the certificate.

(ii) Under the convention, an "authorized person" is an individual designated by the jurisdiction implementing the enabling domestic legislation. Convention, Article 11(1). The signatory countries have "complete discretion" to designate who is an authorized person.

(iii) In the U.S. version of the enabling legislation, only attorneys admitted to the practice of law are authorized persons. Uniform International Wills Act § 9, 8 Unif. Laws Ann. at 266 (1998).

(iv) The drafters' expectation was that civil law signatories would designate notaries as authorized persons because notaries already fulfill such a role in civil law countries. *See* Prefatory Note to Uniform International Wills Act, 8 Unif. Laws Ann. 243, 245 (1998).

3. Limits of the International Will

a. The Washington Convention does not address the revocation of wills, leaving the matter to domestic law. Thus, even if a person executes a valid international will, choice of law issues could possibly arise on revocation. Annex to Convention, Article 14.

b. The Washington Convention also has no effect on the substantive validity of an international will:

> The Convention and the annexed uniform law deal only with the formal validity of wills. Thus, the proposal is entirely neutral in relation to local laws dealing with revocation of wills, or those defining

> the scope of testamentary power, or regulating the probate, interpretation, and construction of wills, and the administration of decedents' estates.

Prefatory Note to Uniform International Wills Act, 8 Unif. Laws Ann. 243, 244 (1998).

c. Finally, an international will is not necessarily formally valid in jurisdictions that have not signed the Washington Convention. The convention, however, is open-ended; a country can sign on to it at any time.

D. *Hague Convention Relating to the Form of Testamentary Dispositions*

1. The Hague Convention Relating to the Form of Testamentary Dispositions of 1961 (the "Hague Convention on Form") was a forerunner to the Washington Convention. In contrast to the Washington Convention, the Hague Convention approaches the question of formal validity through a uniform choice of law rule rather than a uniform law of formal validity.

2. In a country that has adopted the convention, a "testamentary disposition" will be formally valid if it complies with the internal law:

   a. "Of the place where the testator made it, or

   b. "Of a nationality possessed by the testator, either at the time when he made the disposition, or at the time of his death, or

   c. "Of a place in which the testator had his domicile either at the time when he made the disposition, or at the time of his death, or

   d. "Of the place in which the testator had his habitual residence either at the time when he made the disposition, or at the time of his death, or

   e. "So far as immovables are concerned, of the place where they are situated."

   Hague Convention on Form, Article 1.

3. As of May 9, 2013, the following countries were parties to the Hague Convention on Form:

   > Antigua and Barbuda, Armenia, Australia, Austria, Belgium, Bosnia-Herzegovina, Botswana, Brunei, China (Hong Kong only), Croatia, Denmark, Estonia, Fiji, Finland, France, Germany, Greece, Grenada, Ireland, Israel, Japan, Lesotho, Luxembourg, Macedonia, Mauritius, Moldova, Montenegro, Netherlands,

Norway, Poland, Portugal, Serbia, Slovenia, South Africa, Spain, Swaziland, Sweden, Switzerland, Tonga, Turkey, Ukraine, United Kingdom

4. Unlike the Washington Convention, the Hague Convention on Form's choice of law rules apply to matters of revocation as well as execution of testamentary dispositions. Hague Convention on Form, Article 2.

5. The Hague Convention permits a contracting state some flexibility in adopting the general choice of law rule in the convention.

   a. A contracting state, for example, can refuse the application of a law "declared applicable" by the convention if that application would be "manifestly contrary to the 'ordre public.'" Hague Convention on Form, Article 7.

   b. A contracting state can also reserve the right to not recognize certain forms of testamentary dispositions made abroad in the following situations:

      (i) "the testamentary disposition is valid as to form by reason only of a law solely applicable because of the place where the testator made his disposition,

      (ii) "the testator possessed the nationality of the state making the reservation,

      (iii) "the testator was domiciled in the said state or had his habitual residence there, and

      (iv) "the testator died in a state other than that in which he had made his disposition."

      Hague Convention on Form, Article 11.

   c. A state can reserve the right to exclude from the application of the convention any testamentary clauses which, under the law of the state, do not relate to matters of succession. Hague Convention on Form, Article 11.

   d. All of these potential exceptions to the rule, which are not all of the exceptions, essentially require you to determine exactly how the contracting state applies the general choice of law rule in the convention. To this extent, the Hague Convention on Form is not as useful as the Washington Convention.

6. Although the United States is not a party to the Hague Convention on Form, some states have adopted the convention's choice of law rule with respect to the formal validity of wills.

   a. Section 2-506 of the Revised Article II of the Uniform Probate Code, for example, includes this choice of law rule that is very similar to Article 1 of the Convention.

      > A written will is valid if executed in compliance with Section 2-502 or 2-503 or if its execution complies with the law at the time of execution of the place where the will is executed, or of the law of the place where at the time of execution or at the time of death the testator is domiciled, has a place of abode or is a national.

      The prior version of section 2-506 is identical to the revised section.

   b. Many states that have not adopted the Uniform Probate Code have similar provisions in their laws. *See, e.g.*, Cal. Prob. Code § 6113; 25 Pa. Stat. § 2504.1. Illinois, for example, provides that a will that qualifies as an international will under the Uniform International Wills Act will be treated as meeting the signing and attestation requirements for a will under Illinois law. 755 ILCS 5/4-3(b).

7. England implemented the Hague Convention by the enactment of the Wills Act 1963. Under Section 1 of the Act, a will made by a testator after 1963 will be treated as formally valid in England if the will was properly executed:

   a. Under the law of the territory in which the will was executed;

   b. Under the law of the territory where at the time of the testator's execution of the will or death the testator was domiciled or habitually resident; or

   c. Under the law of the state of which the testator was a national.

   This broad statute, which is like that in many U.S. states, should resolve most, if not all, choice of law questions related to formal validity for wills under English law. *See generally* Dicey & Morris on the Conflict of Laws ¶ 27-030 (14th ed. 2006) ("Dicey & Morris"). Other common law jurisdictions follow rules similar to those in the Wills Act 1963. According to Dicey & Morris, legislation similar to that quoted above has been enacted in most of the Australian states and territories (Australia is a party to the Hague Convention on Form), some of the Canadian provinces

and territories, the Isle of Man, Ireland (a party), and South Africa (a party). Dicey & Morris, ¶ 27-029, n. 51.

E. *Choice of Law Rules on Formal Validity in Jurisdictions That Have Not Adopted Multilateral Conventions*

1. In countries that have not adopted the Washington Convention or the Hague Convention on Form, whether a will is formally valid raises a question of private international law: which law applies to determine whether the will is formally valid?

2. In common law countries that have not adopted the Hague Convention, the law is likely to be similar to English law related to the formal validity of wills. Because the law of the U.S. states is very similar to English law as to the validity of a will, a will executed in conformance with the laws of a U.S. state will likely be formally valid in another common law country under that country's domestic law without regard to its choice of law rules. In New Zealand, for example, the English Wills Act 1837 still is the fundamental law of wills. Under Section 9 of the Wills Act 1837, a will is formally valid if it is written and signed by the testator and the signature is made or acknowledged in the presence of two witnesses who in turn attest and sign the will or acknowledge their signatures in the presence of the testator. New Zealand retained the Wills Act 1837 despite an extensive study by the New Zealand Law Commission to update the Wills Act and to conform the New Zealand law of wills to the law of wills in the Australian states. Among other provisions, the Law Commission recommended that New Zealand adopt a provision similar to section 1 of the Wills Act 1963. *See* "Succession Law - A Succession (Wills) Act," New Zealand Law Commission Report 41, October 1997 available online at www.lawcom.govt.nz/uploadfiles/publications). Alternatively, a common law country may have also followed England's lead and enacted a provision similar to section 1 of the Wills Act 1963 that effectively adopts the Hague Convention on Form's choice of law rules with respect for formal validity of a will.

3. In civil law jurisdictions that have not adopted the Hague Convention on Form or the Washington Convention, the formal validity of a will will depend on internal law and the jurisdiction's choice of law rules for succession matters in that country. As discussed in detail below, many civil law jurisdictions follow a nationality principle in choice of law matters. Thus, if a U.S. citizen's will is valid under U.S. law, a civil law country that follows the nationality principle should consider the will formally valid in that country. One issue that will come up, however, is that there is no "national" law of formal validity under the U.S. federal system. If your client is dealing with a civil law country that is not a party to one of these multilateral conventions, local advice should probably be obtained.

V. Is the Client's U.S. Will Substantively Valid in Another Country?

A. *Introduction*

1. If you conclude that your client's U.S. will will be formally valid in another jurisdiction, the next step is to consider whether the will is likely to be substantively valid in that jurisdiction.

2. Whether a will is substantively valid raises two separate sets of questions.

   a. The first set of questions relates to whether the will's execution was substantively valid. For example, a will's execution could be invalid if the will was procured by undue influence or if the testator lacked testamentary capacity to make a will. Questions of this kind are likely to come up in both common law jurisdictions and in civil law jurisdictions.

   b. The second set of questions relates to whether particular provisions in a will are valid under applicable law. Questions of this kind can be quite varied, but include matters such as the effect of a purposed gift in fee tail, whether a gift violates a rule against perpetuities, or whether a will's provisions violate forced heirship laws. Questions of this kind are more likely to arise in civil law jurisdictions than in common law jurisdictions due to the forced heirship laws and lack of trusts in most civil law jurisdictions. Issues of substantive validity of this kind can also arise in common law jurisdictions because the substantive law of trusts and wills often differs among common law jurisdictions.

3. Analyzing these questions of substantive validity involves a preliminary question: What law should you apply to determine whether your U.S. client's will is substantively valid in the foreign jurisdiction? Answering this question requires an understanding of the choice of law rules that will apply in your state and in the foreign jurisdiction in question. When you know which law will apply, you can either answer the substantive validity questions yourself, if the law of your state applies, or refer the question to a lawyer in the other jurisdiction, if the law of that jurisdiction will apply. Would that it would be so easy, however; determining what the choice of law rules will be is in and of itself can be very difficult.

B. *Choice of Law Rules in the United States*

1. Introduction

   a. In order to analyze choice of law questions, a U.S. lawyer must be familiar with U.S. choice of law rules in succession law matters.

b. This part of the outline describes the general U.S. choice of law rules for intestate succession and wills. The choice of law rules for trusts are similar to the choice of law rules for wills and can be found in Restatement (Second) of Conflicts of Law §§ 267-282.

2. Intestate Succession

a. In general, the law of the jurisdiction in which land is located will determine the intestate takers of the land. *See* Restatement (Second) of Conflicts of Law § 236. If a court in a jurisdiction other than the one in which the land was located had to determine the intestate takers of the land, that court would typically refer to the law of the jurisdiction in which the land is located. *See, e.g., Hinchee v. Security National Bank*, 624 P.2d 821 (Alaska 1981)(Alaska court applies Hawaii law to determine creditor's rights in Hawaiian real estate held by a married couple as tenants by the entirety).

b. On the other hand, the disposition of personal property when an individual dies intestate will be determined by the law of the state of the individual's domicile on his or her date of death. Restatement (Second) of Conflicts of Law § 260. *E.g., Estate of Sendonas*, 381 P.2d 752 (Wash. 1963) (applying Washington intestacy laws to estate of Greek national who was domiciled in Washington on the date of his death). Under this principle, a court in a U.S. state other than the state of the decedent's domicile would ordinarily refer to the laws of the jurisdiction of the decedent's domicile to determine the intestate takers of the decedent's personal property. Thus, in two cases involving U.S. property of intestate foreign domiciled decedents, the New York Court of Appeals decided that a decedent's property located in New York would escheat to a foreign country under New York choice of law rules. *Estate of Garwitt*, 393 N.Y.S.2d 702 (N.Y. 1977); *Estate of Utassi*, 261 N.Y.S.2d 4 (N.Y. 1965). The New York Legislature overruled the results of these two cases by providing that if property of a decedent located in New York would escheat to a foreign country, the property will instead escheat to New York. N.Y. Est. Powers & Trust L. § 4-1.5.

3. The choice of law rules that apply to wills differentiate between the validity of wills and construction of wills.

a. Issues of "validity" include capacity, validity of particular provisions of wills, the required form of the will, and the manner of the will's execution. *See* Comment (a) to Restatement (Second) of Conflicts of Law § 263.

b. Issues of "construction," on the other hand, involve the "meaning and effect of words used in the will." *See* Comment (a) to Restatement (Second) of Conflicts of Law § 264.

4. Choice of law rules for wills disposing of real property.

a. In general, the law of the jurisdiction in which the real estate is located will govern issues related to the validity and effect of the will as it relates to that real estate. Restatement (Second) of Conflicts of Law § 239. *E.g., Estate of Moore*, 223 P.2d 393 (Or. 1950) (Oregon law applies to the validity of a will giving land located in Oregon to the federal government); *Estate of Georg*, 298 F. Supp. 741 (D.V.I. 1969) (U.S. Virgin Islands law controls validity and effect of will of domiciliary of the Dominican Republic with respect to land located in the Virgin Islands; law of the Dominican Republic was not applicable to the disposition of the real estate).

b. With respect to issues of construction of a will disposing of land, a U.S. court will generally follow the law designated by the testator in the will.

(i) U.S. choice of law rules do not require that the law selected by the testator have a substantial connection to the testator or to the real estate itself. Restatement (Second) of Conflict of Laws § 240, comment (e).

(ii) In the absence of such a choice of law, a court would generally apply the laws of the jurisdiction in which the real estate is located.

5. Choice of law rules for wills that dispose of personal property.

a. U.S. choice of law rules generally provide that the laws of a decedent's domicile will control the validity and effect of a will to the extent the will disposes of the decedent's personal property. Restatement (Second) of Conflicts of Law § 263. *E.g., In the Matter of the Unanue*, 605 A.2d 279 (N.J. Superior Court 1991) *aff'd* 710 A.2d 1036 (N.J. App. 1998) (decedent was domiciled in New Jersey, not Puerto Rico, so Puerto Rican forced heirship laws did not apply to the decedent's estate); *Estate of Georg*, 298 F. Supp. 741 (D.V.I. 1969) (U.S. Virgin Islands court will respect will of a domiciliary of the Dominican Republic with respect to disposition of personal property located in the Virgin Islands even though the law of the Dominican Republic was different than the law of the Virgin Islands).

b. In a famous case, however, a New York court held that a New York choice of law provision in a will of a French domiciliary trumped French law that would have made the will invalid. In *In the Matter of Estate of Renard*, 437 N.Y.S.2d 860 (Surr. 1981) *aff'd.* 447 N.Y.S.2d 573 (App. Div. 1981) *aff'd.* 439 N.E.2d 341 (N.Y. 1982), the decedent was a U.S. citizen but was domiciled in France on the date of her death. The decedent's U.S. lawyers prepared a will that purported to dispose of all of the decedent's assets and that designated New York law as its governing law. The decedent's New York will left her assets in a manner inconsistent with French forced heirship laws. The decedent later executed a French will that governed her French real estate and tangible personal property located in France. The French will followed French forced heirship principles. The decedent's son, who was her only surviving heir, attempted to claim his right of forced heirship against the property disposed of by the New York will. The court did not recognize the son's claim against the property passing under the New York will because the decedent made a valid choice of New York law in that will and because New York law does not have forced heirship. The court took notice of the general rule that the law of a decedent's domicile should govern issues related to the validity and effect of the decedent's testamentary dispositions of personal property. The court, however, thought that the New York legislature intended to allow individuals to avoid the application of that rule through a New York choice of law. *Id.* at 865 ("Choice of law rules entail the balancing of divers policy considerations and where the Legislature has spoken, its decision should prevail."). The court went out of its way to defend its decision:

> [T]raditional conflict of laws rules often fail to take cognizance of the policies of other jurisdictions, and of the interests which those jurisdictions have in the application of their laws. [Prior decisions] make it clear that the [New York] Court of Appeals has moved away from mechanical choice of law rules to a balancing approach which requires the identification of the underlying policies in the conflicting laws of the relevant jurisdictions, and the examination of the contacts of those jurisdictions to see which has a superior connection with the occurrence and thus a superior interest in having its policy of law followed. . . . The factor of decedent's domicile at death need not be decisive. *Id.* at 866 (citations omitted).

The court thought that the French forced heirship laws conflicted too much with New York's rule of testamentary freedom to give

effect to those French laws when the decedent deliberately chose New York law:

> France apparently applies its forced heirship law to personal property situated in that country, without regard to the fact that neither the testator nor the claiming child is domiciled there, so long as the child is a citizen of France. In this court's view the weight of the contacts with each jurisdiction must be considered. The French approach may reward a child's recent acquisition of French citizenship or residence with a windfall in the way of a forced share in the parent's estate. Our conflicts rules should not be extended to sanction such an approach, which might reward such changes made in contemplation of imminent death. *Id.* at 867 (citations omitted).

c. On matters of construction a court will generally follow the law designated by the testator in the will. Restatement (Second) of Conflicts of Law § 264(1).

(i) Choice of law rules in the United States do not require that the testator have a substantial connection to the jurisdiction the law of which he or she selects. Comment (e) to § 264.

(ii) If the testator did not make such a choice of law in his or her will, a court will generally apply the laws of the testator's domicile at his or her date of death in construing the will. Restatement (Second) of Conflicts of Law § 264(2). *E.g., Buresh v. First National Bank*, 500 P.2d 1063 (Or. App. 1972) (California law governs construction of will of California resident even though will prepared in Oregon).

C. *Choice of Law in Common Law Jurisdictions Other Than the United States*

1. Other common law jurisdictions' choice of law rules are very similar to the U.S. rules given the common source of those rules: English law. The primary impetus for the development of these rules in, English law was the commerce and movement of people and property between England and Scotland. *See generally* Dicey & Morris, ¶ 1-018. The rules come in handy in analyzing conflicts between common law countries and conflicts between subdivisions of federal systems, such as the provinces and territories of Canada and the states and territories of Australia.

2. As is the case in the United States, the common law countries' choice of law rules usually provide that the law of the location of immovable

property governs succession law matters related to that property. Dicey & Morris, ¶¶ 27-016, 27-053. *See, e.g., Re Collens* [1986] 1 Ch 505, [1986] 1 All ER 611 (English law applies to disposition of English real property by domiciliary of Trinidad and Tobago); *Re Bailey* [1985] 2 NZLR 656, 1984 NZLR LEXIS 737 (New Zealand court applies English law to determine a widow's right in real property in England); *In re Ogilvie* [1918] 1 Ch 492 (English court applies Paraguayan law to determine succession law issues related to an English-domiciled decedent's interest in Paraguayan real property). This means that when you have a U.S. client with real property located in a common law country, then that country will apply its own law in a matter related to the succession to that real property. A court in a U.S. state would almost certainly apply the law of the other country if the court had to resolve a succession law issue related to that property.

3. The common law countries generally base choice of law on succession matters related to movable property on the decedent's domicile at his or her date of death. Dicey & Morris, ¶¶ 27-011, 27-045. The U.S. states follow a similar rule absent a choice of law to the contrary by a decedent. In this way, the U.S. and common law country rules for choice of law on succession matters complement one another.

4. Just because the rules are complementary, does not mean that the provisions of your client's U.S. will will be valid in a common law country because the wills and trusts laws of the common law jurisdictions vary considerably. An English case illustrates the pitfalls a lawyer may encounter in this area. In *Tod v. Barton* [2002] EWHC 264 (Ch.), a Texas domiciliary made two last wills, one for his U.S. property and one for his other property. The latter will was an English will and provided that the will was to take effect under English law. The English will essentially created an annuity trust for the decedent's son with the remainder of the trust assets passing to charity. Pursuant to English law, the son and the charity agreed to vary the trust, resulting in the payment of a lump sum to the son and the acceleration of the charitable remainder. The decedent's widow objected, claiming that the testator would have wanted the son to receive an annuity, not a lump sum. According to the widow, Texas law, which was the law of the decedent's domicile, would not permit such a variation because the substantial purposes of the trust had not been accomplished (the "*Claflin*" rule). English law, on the other hand, would permit such a variation under the famous case of *Saunders v. Vautier*. The court held that despite the testator's Texas domicile, English law applied because the testator specified that his English will was to take effect under English law.

D. *Choice of Law In Civil Law Countries*

1. Many civil law countries base their choice of law rules in succession law

matters on the decedent's citizenship (*lex patriae*), not the decedent's domicile.

2. For example, under German choice of law rules the disposition of the personal property of a German national is governed by German law even if he or she is domiciled in another country. German choice of law rules provide that the disposition of German real estate is also governed by the law the owner's nationality. Italy, Spain, and Sweden rely on similar choice of law rules in succession matters.

3. A case from the Philippines illustrates how a citizenship-based choice of law rule will apply in a civil law country. In *Estate of Bellis,* 20 Philippine Supreme Court Reports Annotated 358 (1967), the decedent was a U.S. citizen who resided in Texas. The decedent had executed a will in the Philippines to govern his Philippines estate, and some of the provisions of the will violated Philippines forced heirship law. Following the decedent's death this will was probated in the Philippines. The Supreme Court of the Philippines refused to recognize the claims based on the Philippines forced heirship law, given the decedent's U.S. citizenship. Rather, the court held that Texas law applied. Because the parties admitted that Texas did not have any applicable forced heirship laws, the aggrieved children had no right to a share of the decedent's estate located in the Philippines.

4. The Scandinavian countries other than Finland rely on citizenship in choice of law matters involving succession law except with respect to choice of law among the countries themselves. As between the Scandinavian countries other than Iceland, a 1934 multilateral treaty, the Nordic Convention on Succession, provides that domicile is the basis for choice of law with respect to choice of law issues between citizens of those countries. *See generally* 1 Schoenblum, § 9.05, 9-28.

5. Finland recently changed its conflicts of law rules in succession matters to emphasize domicile rather than citizen. Under Finnish choice of law rules, the law of a decedent's country of domicile applies to the disposition of property located in Finland as long as the decedent was a citizen of his or her country of domicile or had his or her permanent home in the country of domicile during the five years before death. If the law of the decedent's domicile does not apply pursuant to this rule, Finland will rely on citizenship for choice of law matters. These rules are described in a report by Urpo Kangas of the University of Helsinki for the Study on Conflict of Law of Succession in the European Union, which is available in English at http://europa.eu.int/comm/justice_home/doc_centre/civil/studies/doc/report_conflits_finland.pdf).

6. Although France is the source of much of the world's modern civil law, France actually relies on domicile in choice of law on succession law

matters, as does Belgium. France and Belgium also follow the common law choice of law rule that the law of the location of immovable property governs succession law matters related to that property. To this extent, there should not be a conflict of choice of law rules between a U.S. state and France or Belgium. For example, if a U.S. citizen and resident decedent dies owning real property in France, a French court would apply French law to determine the rights of the decedent's heirs and legatees in the property. The application of French substantive law in this situation would be consistent with U.S. choice of law rules. In this situation, French forced heirship law could restrict the decedent's testamentary freedom with respect to the French real property. In addition, leaving French real property to a trust would not work because French law does not recognize trusts.

7. Switzerland generally relies on domicile as the basis for choice of law matters involving non-Swiss national individuals who are not domiciled in Switzerland. Thus, in the case of a U.S.-domiciled U.S.-national decedent who owned personal property located in Switzerland, a Swiss court would apply the succession law of the state of the decedent's domicile. If a U.S. citizen who was domiciled in the United States owned real property in Switzerland, however, a Swiss court could apply Swiss law to succession law matters related to the real property under either Swiss choice of law rules or the 1850 United States – Switzerland Treaty of Friendship, Reciprocal Establishments, Commerce, and Extraditions. If, however, a U.S. court asserted jurisdiction over Swiss real property in a succession law matter involving a U.S. citizen domiciled in the United States, a Swiss court would yield to the U.S. court's jurisdiction. Arpagus, "Estates Involving the United States and Switzerland," at 7 (2003)(available online at www.swissemb.org/legal/estate.pdf).

8. By way of reference, U.S. courts have shown a general lack of enthusiasm for recognizing forced heirship claims based on the laws of the decedent's country of citizenship. Courts that have considered questions of this kind usually have found an explicit or implicit choice of U.S. state law by the decedent that justifies the application of U.S. principles of testamentary freedom rather than foreign forced heirship laws. *See, e.g., Matter of Meyer,* 876 N.Y.S.2d 7 (N.Y. App. 2009)(applying New York law rather than French forced heirship law to inter vivos transfers of property located in New York and otherwise rejecting French forced heirship law-based claims); *In the Matter of Estate of Renard*, 437 N.Y.S.2d 860 (Surr. 1981) (applying New York law rather than French forced heirship law); *Wyatt v. Fulrath*, 211 N.E.2d 637 (N.Y. 1965) (applying New York law rather than Spanish community property law); *Neto v. Thorner*, 718 F. Supp. 1222 (S.D.N.Y. 1989) (applying New York law rather than Brazilian forced heirship law); *Sanchez v. Sanchez*, 547 So.2d 943 (Fla. App. 1989) (applying Florida law rather than Venezuelan forced heirship law).

E. *Renvoi*

1. A conflict between choice of law rules can occasionally arise for a U.S. domiciled client who owns real property located in a civil law country that follows a nationality principle in choice of law rules. For example, if an Illinois domiciled decedent owned real property in Spain, the Illinois choice of law rules would provide that Spanish law should apply to succession law matters related to that real property. Spanish conflicts law, however, generally provides that the law of a decedent's nationality controls all succession law matters. What happens with such a conflict?

2. Such a conflict triggers the potential application of the doctrine of *renvoi. Renvoi* arises when the conflicts rules of a U.S. state refers a matter to the "law" of another jurisdiction. Such a referral raises the question of whether the referral is to the substantive law of the other jurisdiction or to the substantive law and the choice of law rules of the other jurisdiction.

3. American courts generally interpret a reference to the "law" of another jurisdiction as a references to the substantive law of that jurisdiction and not the conflict of law rules of that jurisdiction. Restatement (Second) of Conflicts of Law § 8(1).

4. An exception to the general rule of no *renvoi* in U.S. courts, however, involves succession law matters related to foreign real property. Under the U.S. approach, a succession law matter related to foreign real property owned by a U.S. decedent is litigated in a U.S. court, that court is likely to apply what scholars refer to as "double *renvoi*."

    a. In this situation, the U.S. court would attempt to decide the case in the same manner as a court in the other country, applying both the substantive law and the choice of law rules of that country. *See generally* Restatement (Second) of Conflicts of Law § 8(2).

    b. Taking this approach requires proof of both the substantive law and the conflicts law of the foreign country. The court will first have to determine whether the foreign country will accept the "transmission" of the governing law from the U.S. state under that state's choice of law rule. If the court concludes that the foreign country will accept the transmission of choice of law, then the U.S. court would apply the substantive law of the foreign country with respect to succession law matters. If the U.S. court concludes that a court in the foreign country would not accept the transmission from the U.S. court, then the U.S. court will apply its substantive rules.

    c. There are very few cases involving *renvoi* in this context in the United States. The leading U.S. case involving *renvoi* in

succession law matters is *Accounting of Schneider*, 96 N.Y.S.2d 652 (Surr. 1950). In that case, the Surrogate's Court for New York County considered whether to apply Swiss or New York law with respect to a succession law matter involving the proceeds from the sale of a decedent's Swiss real property. The court took the position that it should decide the case in the same way that a Swiss court would decide the case. The court noted that Switzerland followed the nationality principle in succession law matters and would not accept the *renvoi* from New York. Accordingly, the court applied New York law to determine the parties' rights in the proceeds. The Delaware Court of Chancery in a 1954 case applied double *renvoi* to conclude that an Italian court would have applied the law of Mississippi to the estate of a non-Italian citizen domiciled in Italy. *Taormina v. Taormina Corporation*, 109 A.2d 400 (Del. Ch. 1954). The court's discussion of the choice of law matter, however, is dicta because the court had previously concluded that the decedent was in fact domiciled in Mississippi.

5. The English courts have generally followed the same double *renvoi* approach in cases concerning succession law matters related to foreign real property that are litigated in England. *See, e.g., In re Duke of Wellington* [1947] Ch 506 (English law applies to determine succession law matters related to Spanish real property owned by domiciliary of England). English courts have also applied double *renvoi* in cases involving movable property of British citizens who were domiciled in civil law countries that follow a nationality principle in choice of law matters. *E.g., In re Ross* [1930] 1 Ch 377 (English law applies to determine succession law matters related to Italian real property owned by a U.K. citizen who was domiciled in Italy).

6. Civil law countries that follow a nationality principle in succession law matters sometimes eschew *renvoi* because it could result in the non application of citizenship as the basis for choice of law depending on the nationality of the individual in question.

7. Germany, on the other hand, will accept *renvoi*. *See* 1 Schoenblum § 9.10 at 9-52, n. 272. Thus, if a U.S. citizen domiciled in Germany owns real property in Germany, German law would initially refer to U.S. law with respect to succession law issues related to the property. A U.S. court, however, would refer to German law under U.S. choice of law rules. A German court should accept this reference and apply its substantive law with respect to the real property. Thus, a gift of German real estate would be subject to German forced heirship rules. Similarly, a gift of German real property to a trust might not be recognized because trusts are not a part of German law. Consistent with this general principle, an English court relied on German law in a case involving personal property of a

German domiciled decedent that was physically located in England. *Estate of Fuld* [1968] P. 675.

F. *Multilateral Treaties on Substantive Succession Law Issues*

1. The Hague Convention Relating to the Form of Testamentary Dispositions and the Washington Convention, while useful in matters of formal validity, address only issues related to the formal validity of wills. The treaties do not address substantive legal issues that can arise in succession law matters, leaving those issues to private international law. As demonstrated by the above discussion, relying on private international law can lead to difficult analytical situations.

2. The members of the Hague Convention addressed choice of law issues related to substantive succession law matters in the 1989 Hague Convention on the Law Applicable to Succession to the Estates of Deceased Persons (the "Hague Convention on Succession").

   a. The Hague Convention on Succession attempted to come up with a uniform set of choice of law rules for substantive succession law matters. The main principles of the convention are:

      (i) The location of property and a decedent's domicile are irrelevant to choice of law questions.

      (ii) Choice of law in succession law matters must be based on the law of the country of which a decedent was a citizen provided he or she was habitually resident in that country. If the decedent was habitually resident in a country other than his or her country of citizenship, the law of the country of habitual residence will apply as long as the decedent had been so resident in that country for five or more years before his or her death. If the decedent was not a citizen of the country in which he or she was habitually resident for less than five years preceding his or her death, the law of his or her country of citizenship applies to succession law matters. Hague Convention on Succession, Article 3.

      (iii) A decedent can choose the law governing the disposition of his or her estate, but the law must either be the law of the country of which he or she is a national or of the country of which he or she is habitually resident. *Id.* Article 5(1). A testator cannot choose the law of more than one country.

      (iv) The Hague Convention on Succession has no real significance in international succession law matters at this

point. Only Argentina, Holland, Switzerland, and Luxembourg have signed the convention. Of these four countries, only Holland has ratified the convention. Holland also has implemented the choice of law provisions in the convention into its domestic law, so its choice of law rules on succession matters mirror those in the convention. As discussed above on page 33, Finland recently changed its choice of law rules to reflect the provisions of the convention, although Finland is not a signatory to the convention.

3. The 1985 Hague Convention on the Law Applicable to Trusts and on Their Recognition (the "Hague Convention on Trusts") may make it possible to use trusts to hold property with a connection to a jurisdiction that does not recognize trusts as part of its domestic law.

   a. Like the Hague Convention on Succession matters, the Hague Convention on Trusts is an attempt to harmonize choice of law rules so that one country will recognize a trust that is valid in another country. The convention does not require a party to adopt a domestic law of trusts. In addition, a signatory does not have to recognize a trust if its "significant elements" other than its choice of law, its place of administration, and the habitual residence of the trustee, "are more closely connected" to a state that does not recognize the trust as part of its domestic law.

   b. The following countries have ratified the Hague Convention on Trusts:

      Australia, Canada (subject to certain reservations and the nonapplication of the convention in Quebec), China (for the Hong Kong special administrative region only), Italy, Liechtenstein, Luxembourg, Malta, Monaco, Netherlands, San Marino, Switzerland, United Kingdom (including many of its territories, including Bermuda, Gibraltar, and the Isle of Man).

   The United States, Cyprus, and France each signed the convention, but none of these countries has ratified it. The convention entered into force in Switzerland in 2007. According to a press release from the Swiss Federal Office of Justice issued before ratification:

   > A large volume of assets belonging to trusts or managed in the name of trusts [are] held in Switzerland. More and more banks have their own trust departments, while increasing numbers of Swiss-domiciled companies specialize in their

> management. Fiduciary companies and law firms are other players which are becoming increasingly involved in trust planning and administration.
>
> Although trusts are already broadly recognized under current Swiss law, the present legal situation is still encumbered with considerable uncertainty. The recognition of trusts is thus to be given a firm foundation, with more legal certainty created for all concerned. Both the parties involved in trusts and the relevant authorities have a vested interest in a system that sets out with the greatest degree of certainty the legal provisions which apply to trusts in individual cases. There is also a significant economic interest in greater legal certainty, as a sound legal basis improves conditions for the establishment and management of trusts and thereby boosts the appeal of Switzerland as a business location.
>
> For the reasons given above, Switzerland is planning to ratify the Hague Convention on the Law Applicable to Trusts and on their Recognition in the near future.

Press Release, "Ratification of the Hague Trust Convention," June 2005, Swiss Office of Federal Justice (available online at www.finweb.admin.ch/pdf_neue_neue_version/pdf_e/FS_Haager Trust_BJ_e.pdf).

c. Under Article 11 of the convention, a party must recognize a trust if that trust was created in accordance with the law of a country that recognizes trusts:

> A trust created in accordance with the law specified by the preceding [provisions of the convention] shall be recognized as a trust. Such recognition shall imply, as a minimum, that the trust property constitutes a separate fund, that the trustee may sue and be sued in his capacity as trustee, and that he may appear or act in this capacity before a notary or any person acting in an official capacity.

d. In particular, Article 11 provides that a party must recognize these features of trusts to the extent that the law governing the trust so provides:

> In so far as the law applicable to the trust requires or provides, such recognition shall imply, in particular -
>
> (i) That personal creditors of the trustee shall have no recourse against the trust assets;
>
> (ii) that the trust assets shall not form part of the trustee's estate upon his insolvency or bankruptcy;
>
> (iii) that the trust assets shall not form part of the matrimonial property of the trustee or his spouse nor part of the trustee's estate upon his death;
>
> (iv) that the trust assets may be recovered when the trustee, in breach of trust, has mingled trust assets with his own property or has alienated trust assets. However, the rights and obligations of any third party holder of the assets shall remain subject to the law determined by the choice of law rules of the forum.

e. The convention also provides that a country must permit a trustee to register title to movable and immovable assets in the trustee's fiduciary capacity "in so far as this is not prohibited by or inconsistent with the law of the State where registration is sought." Hague Convention on Trusts, Article 12. In making such a registration, the country's government may require the disclosure of evidence that discloses the trust's existence. In other words, the trustee must register the property with some reference to the fact that he or she owns the property as trustee and not individually.

f. If a party to the convention must resolve an issue related to the trust, it will apply the law chosen by the settlor of the trust. If the settlor did not make a choice of law or chose the law of a jurisdiction that does not recognize trusts, the court will apply the law of the jurisdiction with which the trust is most closely connected. *Id.* Article 7. The facts that will determine that jurisdiction are:

> In ascertaining the law with which a trust is most closely connected reference shall be made in particular to:

(i) the place of administration of the trust designated by the settlor;

(ii) the situs of the assets of the trust;

(iii) the place of residence or business of the trustee;

(iv) the objects of the trust and the places where they are to be fulfilled.

g. Article 13 of the convention contains an "escape clause" that allows judges to decide that despite the convention a trust should not be recognized:

> No state shall be bound to recognize a trust the significant elements of which, except for the choice of the applicable law, the place of administration and the habitual residence of the trustee, are more closely connected with states which do not have the institution of the trust or the category of trust involved.

According to the Explanatory Report on the convention by Alfred von Overbeck ("von Overbeck Report"):

> This clause will be used above all by judges who think that the situation has been improperly removed from under the application of their own laws. But it might also be utilized by the judge of one State which does not have trusts as a matter of solidarity with another State, which also does not have them and to which the situation is objectively connected.
>
> It will also be noted that this provision allows a judge of a State which does not have trusts to refuse recognition to the trust because he thinks that the situation involved is internal to his State. In contrast this possibility does not exist for those States which have trusts, but those States do not seem to feel the need for it.

Von Overbeck Report at 387 (available online at http://hcch.e-vision/nl/upload/exp130.pdf).

h. The convention has a few other "escape clauses" that will allow a signatory to avoid recognizing a trust.

(i) Article 15 in effect provides that the convention will not alter the domestic choice of law rules of a country on succession law issues other than issues related to the recognition of trusts. For example, the convention does not change a country's choice of law rules with respect to the "protection of minors" and "the personal and proprietary effects of marriage." The convention also does not apply to "succession rights, testate and intestate, especially the indefeasible shares of spouses and relatives." Hague Convention on Trusts, Article 15(c).

(ii) Article 16 provides that certain domestic laws related to "international situations" are not affected by the convention. The purpose of this provision was to allow a country to apply its really important domestic laws that generally override the country's choice of law rules in certain international situations:

> Among the laws which fall in this category, mention may be made of those which are intended to protect the cultural heritage of a country, public health, certain vital economic interests, the protection of employees or of the weaker party to another contract.

Von Overbeck Report at 44.

i. Even though the United States has not ratified the convention, a U.S. person can receive the benefit of the convention in the countries that have adopted the convention. Christensen, *supra*, at 7.

4. In 2012 the European Union adopted a regulation on succession that starting in 2015 will govern the choice of law as it relates to decedents' estates among most, but not all, E.U. countries. The general rule under the regulation is that the law of the decedent's habitual abode will govern succession matters on the decedent's death. The regulation, however, also allows a decedent under some circumstances to choose the law of his or her country of citizenship to control. The regulation also attempts to centralize authority to deal with succession matters in a decedent's estate in the country of the decedent's habitual abode. The regulation does not involve a Europe-wide substantive law of succession. Instead, it attempts to resolve cross-border succession issues by standardizing the choice of law rules. The following E.U. countries opted out of the regulation: United Kingdom, Ireland, and Denmark.

VI. How Should a Client Dispose of Foreign Assets in U.S. Estate Planning Documents?

A. You may conclude that because of choice of law rules or because of substantive law rules in the other country that the provisions of the U.S. will are valid in that country. You should not, however, therefore assume that leaving the property in the manner contemplated by the client's U.S. estate planning documents is necessarily the best idea for that property.

B. From a nontax law perspective, simplicity is often best, particularly when the property is located in a civil law country.

1. A U.S. lawyer's instinct may be to leave a decedent's estate in one or more trusts of various kinds. A gift to a trust will be given effect in a common law country such as England. A gift to a trust may also be given effect in a civil law country if its choice of law rules or its domestic law would recognize a gift to a trust. Just because such a gift is possible, however, does not mean that it is advisable.

2. If a civil law country has adopted the Hague Convention on Trusts, it may be possible to register the property in the name of the trustee. The Hague Convention on Trusts directs signatory states to permit such registrations, but it allows a country to not do so if doing so is "prohibited by or inconsistent with the law of the State where registration is sought." Hague Convention on Trusts, Art. 12.

3. In a civil law country that has not adopted the Hague Convention on Trusts, registering real property in the name of a trustee may be difficult to do even though as a matter of succession law the gift of the property to the trust was permissible. For example, the registration may disclose only the name of the trustee and not reflect the fact that the property is owned by a trust. The Chancery Court in *In re Duke of Wellington* [1947] Ch 506, addressed this issue:

> It appears from the expert evidence that, so far as immovable property in Spain is concerned, there is a system of compulsory registration, and that in order to perfect title to immovable property or to any interest therein, such as a usufruct, it is necessary to obtain registration. The experts agree that Spanish law does not recognize the doctrine of trusts as understood in English law, and that it is not possible in Spanish law to obtain registration of a trust. They are also agreed, however that the mere presence in a document of title, including a will, of the word "trust" would not, of itself, be fatal to registration, and that, assuming English law to be applicable in the case in questions, the registrar and, if

necessary, the Spanish court would seek competent English opinion as to the effect of the document in question.

4. A particular problem may arise in a common law country when the U.S. client uses a pour-over will and real property located in the country is covered by the pour-over provision, rather than a specific gift. For example, it is unclear in Canada whether a gift by a will to a revocable trust that has been amended since the execution of the will is valid. Such a gift raises issues under the incorporation by reference doctrine that is part of the common law of wills, which the U.S. states have addresses through testamentary additions to trust legislation.

5. These kind of issues suggest favoring simplicity, such as using outright specific gifts to individuals when you can. Gifts of this kind are easy to understand, easy to translate into a foreign language, and do not introduce U.S. legal concepts and principles into a foreign situation.

C. Many U.S. estate planning conventions and devices can lead to infelicitous foreign tax consequences.

1. For example, although many civil law countries follow the nationality principle in choice of succession law matters, estate and inheritance taxes in those countries may be based on the location of property.

a. As noted above, civil law countries often have inheritance taxes that impose a higher rate of tax on gifts to more remote relatives than on gifts to close relatives. If such a country relies on nationality in its choice of law rules related to succession, a bequest by a U.S. citizen to a friend or remote relative should not violate the country's forced heirship laws. On the other hand, because the devisee is not closely related to the decedent, the country may apply a higher rate of tax to the bequest. Thus, while the gift may be substantively valid, the price for making it is higher.

b. As discussed above, under Swiss choice of law rules a Swiss court is likely to apply U.S. succession law to the estate of a U.S. citizen. Thus, a U.S. citizen who owned real property in Switzerland could technically leave that property to a trust. If the canton in which the property is located, however, has an inheritance tax, the canton may treat the bequest to the trust as a bequest to a nonfamily member, triggering inheritance tax at the highest rate. More dramatically, some of the Swiss cantons do not impose an inheritance tax on a transfer of property to descendants. A gift to a trust for the benefit of descendants, however, may be treated as a gift to an unrelated person, thereby attracting inheritance tax when it would not otherwise be payable. In this situation, the benefit of

being able to use a trust is outweighed by the tax consequences. With respect to this last point, some cantons may permit a gift to a trust solely for the benefit of descendants to be treated as a gift to a descendant, but an advance ruling will be necessary to secure this favorable treatment.

2. Making gifts of foreign property to U.S.-style trusts may also cause foreign estate and inheritance tax problems.

   a. For countries that still have estate taxes and gift taxes, gifts and bequests to trusts for the benefit of U.S. beneficiaries may trigger wealth transfer taxes in the donor's country of residence. While the imposition of foreign wealth transfer taxes in and of itself may not be surprising, how other countries apply those taxes may be surprising. Note that the Hague Convention on Trusts does not apply to fiscal matters, so a party to the convention is free to tax trusts as it wishes.

   b. German gift and inheritance tax law, for example, bases its gift tax and inheritance tax rates on the relationship of the donor to the donee. A client, for example, may own an interest in a German partnership that is subject to German gift tax. A descendant is a Class I beneficiary; the top marginal rate for gifts or bequests to such a beneficiary is 30% (above €26 million (about $35 million)). The general view in Germany is that a trust is a Class III beneficiary regardless of the identity of the trust beneficiaries. The top marginal rate on a gift or bequest to a Class III beneficiary is 50% (above € 26 million). Thus, a gift to a trust can trigger a higher German gift tax than would a gift to an individual.

   c. Giving English real property to a U.S.-style trust seems like it should be simple because the law of England recognizes trusts. A bequest of English real property to a trust, however, may result in the trust paying a U.K. inheritance tax every 10 years – the "ten-yearly charge" of up to 6%. A charge may also apply on large distributions from the trust.

   d. Often the safest way to proceed is to prepare U.S.-style documents that mirror the optimal tax consequences in the taxing countries. Avoiding the use of trusts, while anathema to U.S. estate planning lawyers, may often be necessary to avoid unfortunate foreign tax results as long as the tax laws of the other country apply.

3. Even in countries without estate taxes, such as Canada, U.S.-style gifts to trusts, rather than outright gifts, may cause income tax issues. For example, a U.S. citizen who resides in the United States is generally subject to Canadian capital gains tax when he or she transfers appreciated

Canadian real estate to a trust. Furthermore, the trust will be deemed to have disposed of the property for Canadian capital gains tax purposes every 21 years, absent some intervening taxable event with respect to the property.

4. In this situation, a lawyer generally should consult with lawyers and tax advisers in the other country to determine the most appropriate way to prepare the client's estate planning documents during this interim period until the U.S. tax system alone applies to the decedent's estate.

VII. U.S. Gift and Estate Tax Issues

A. *Introduction*

1. A U.S. citizen's worldwide estate is subject to U.S. estate tax on his or her death. If the decedent's estate includes property located in or connected to a foreign country, the decedent's estate tax return will include that property and the estate will pay tax on the property.

2. This simple rule of inclusion raises a considerable number of U.S. estate tax issues. While the most obvious might seem to be double taxation, there are a number of other tricky issues with which to contend.

3. This section of the outline discusses some of the important federal estate tax issues that may come up for clients who own foreign property.

B. *Identification and Description of Foreign Property*

1. All descriptions of property on a federal estate tax return, of course, must be in English. Thus, the executor must obtain translations of relevant documents that will be included with the federal estate tax return. This may present issues when attempting to translate legal descriptions of real property located in another country.

2. All values reported on a federal estate tax return must be in U.S. currency, even for foreign financial assets. The exchange rate to use is the "commercial (or retail) exchange rate, stated in United States dollars, established by the United States financial centers on the valuation date." P.L.R. 8927038 (involving valuation of bank accounts, time deposits, retirement accounts, and other financial accounts in Canada). The "buy" rate is not an appropriate rate to use in these computations. If the decedent died on a weekend day, the executor must use a weighted average of commercial exchange rates based on the principles of Treas. Reg. § 20.2031-2(b)(2).

3. A decrease in the U.S. dollar against the relevant foreign currency between the date of death and the alternate valuation date may make an

alternate valuation date election available even if the foreign assets have not been reduced in value using the local currency as a measurement.

C. *Valuation of Foreign Property*

1. Neither the Code nor the Treasury Regulations have any special rules for valuing foreign property. Accordingly, the general fair market value standard of value applies for all of a decedent's foreign property. *See generally* Treas. Reg. § 20.2031-1(b).

2. If a decedent owned real estate located in a foreign country, the decedent's executor should obtain an appraisal of the real estate by an appraiser or other expert in that country, and the appraiser or other expert should use U.S. principles in determining fair market value. *See, e.g.*, *Estate of Proios v. Commissioner*, T.C. Memo. 1994-442, 68 T.C.M. 645 (1994)(Greek real estate valued by an expert who had particular experience with the real estate market in Piraeus).

3. If a decedent owned shares traded on a foreign stock exchange, the executor should follow the general principles in Treas. Reg. § 20.2031-3 in determining the value of the shares. The internet and its multitude of web sites devoted to financial matters have made this task considerably easier than it used to be.

4. If the decedent owned an interest in a closely held foreign company, the executor will have to determine the fair market value of the interest in a manner consistent with Treas. Reg. § 20.2031-3 and Rev. Rul. 59-60, 1959-1 C.B. 237. Absent actual sales of similar interests in the same company, an appraisal will be necessary. The appraiser or other expert should use market data from the foreign country to determine the fair market value of the company interests. The Tax Court's memorandum decision in *Estate of Schneider-Paas v. Commissioner*, T.C. Memo. 1969-21, 28 T.C.M. 81 (1969), demonstrates the complexities of valuing a decedent's shares in a foreign corporation, in that case a German corporation. The court took 40 pages to describe the complicated evidence of valuation, which included testimony of experts who were familiar with the German securities. The court acknowledged that deciding the case was difficult because not only did it involve the valuation of a closely-held company, it was a German company at that: "In addition to the problems that must be considered in valuing the shares of a closely held American corporation, consideration in this case must be given to the fact that the shares to be valued are of a German company." 28 T.C.M. at 85.

5. One issue that used to regularly come up in estate tax cases was the valuation of foreign currency that was subject to exchange controls, such as currency located in occupied European countries during the Second

World War. In such a case, the estate tax value of the currency must reflect restrictions imposed by exchange controls and similar rules. In spite of exchange controls, there is usually a commercial market for restricted currency; the rate used in that market controls. *See, e.g., Estate of Fokker v. Commissioner*, 10 T.C. 1225 (1948)(involving Dutch guilders); *Landau v. Commissioner*, 7 T.C. 12 (1946)(involving South African pounds). Courts have applied similar rules to valuing blocked securities. *E.g.*, *Estate of Nienhuys v. Commissioner*, 17 T.C. 1149 (1952)(property located in the Netherlands during the Second World War); *Estate of Fry v. Commissioner*, 9 T.C. 503 (1947)(shares in a British corporation that could not be transferred outside of the United Kingdom). These issues still come up today because some countries still have exchange controls, including South Africa and Brazil.

D. *Avoiding Double Taxation of Foreign Wealth Transfer Taxes*

1. Introduction

a. The estate of a U.S. citizen or resident decedent may face double death taxes on account of the decedent's ownership of property in a foreign country. In some situations, however, either a tax treaty or the IRC § 2014 credit for foreign death taxes may alleviate double taxation.

b. The United States has estate tax treaties with the following countries: Australia, Austria, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland, and the United Kingdom. The newer U.S. estate tax treaties (Austria, Denmark, France, Germany, the Netherlands, and the United Kingdom) (the "OECD Treaties") are based more or less on the OECD Model Estate Tax Treaty. All but one of the older treaties (Australia, Finland, Greece, Ireland, Italy, Japan, Norway, South Africa) on the other hand, emphasize the situs of property. The two kinds of treaties are considerably different in how they apply to estates of U.S. citizen decedents. The Switzerland treaty does not fit within either category.

2. OECD Treaties

a. The OECD treaties generally provide that the country in which the decedent is not domiciled (determined under the treaty rules) can tax only certain items of property with a connection to that country. *See* 1982 OECD Model Estate, Inheritance, and Gift Tax Convention, Articles 5 and 6. The OECD treaties allow the country of domicile to tax all the other items of property passing on the decedent's death. If the country of domicile also taxes the property located in the other country, the country of domicile must

generally provide a credit against that country's tax for the situs country's tax. *Id.* Article 7. The United States, for example, generally reserves the right to tax estates of its citizens as if the treaty was not in force. *E.g.,* Convention Between the United States of America and the Republic of Austria for the Avoidance of Double Taxation and the Prevention of fiscal Evasion with Respect to Taxes on Estates, Inheritances, Gifts, and Generation-Skipping Transfers, TIAS 10570, Article 9(1). If a country can tax on the basis of situs under the treaty and the United States can tax on the basis of citizenship, the United States must allow a credit for the foreign death taxes. *E.g., id.,* Article 9(2).

b. The OECD treaties generally provide that the nondomiciliary country has primary taxing authority over the following items of property of a decedent's estate:

   (i) Real property located in the nondomiciliary country; and

   (ii) Business property of a permanent establishment located in the nondomiciliary country.

c. Some of the OECD treaties give the nondomiciliary country primary taxing authority over other items of property with a connection to that country.

   (i) The Germany treaty allows the nondomiciliary country to tax the decedent's interests in partnerships that do business in that country. Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with respect to Taxes on Estates, Inheritances, and Gifts, TIAS 11082, Article 8.

   (ii) The France treaty allows the nondomiciliary country to tax the decedent's interests in tangible movable property other than currency located in that country. Convention Between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Estates, Inheritances, and Gifts, TIAS 9812, Article 7(1). The situs country, however, cannot tax tangible movable property "used for… normal personal use" of a decedent or his or her family; only the domiciliary country may tax that property. *Id.*, Article 7(2).

   (iii) The 2004 protocol to the France treaty gives the United States and France primary taxing rights over partnerships

and other pass through entities that own business assets in their respective countries. The protocol also adopted a special rule that treats shares of stock in companies that own French real estate as French situs assets under some circumstances. *See generally* Protocol Amending the Convention Between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Estates, Inheritances, and Gifts, Signed at Washington on November 24, 1978. The protocol entered into effect on December 21, 2006.

d. The OECD treaties use two principal mechanisms to avoid double taxation.

(i) The first mechanism is an exemption from tax.

(a) Under the OECD treaties, all items of a decedent's property other than those specifically "allocated" to the nondomiciliary country are subject to wealth transfer tax *only in the decedent's country of domicile*.

(b) This rule can provide a substantial exclusion from foreign death taxes on foreign assets owned by U.S. citizens and residents that would otherwise be subject to inheritance tax or estate tax in the foreign country.

(c) For example, a U.S. citizen who resides in the United States will be subject to U.K. inheritance tax only on his or her U.K. real estate and some business assets, but not his or her shares in U.K. companies or debts of U.K. persons, including nonqualified deferred compensation promises from U.K. companies. *See* Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Estates of Deceased Persons and on Gifts, TIAS 9580, Articles 5-7.

(ii) The other principal mechanism used by the OECD treaties to avoid double taxation is a credit against tax.

(a) Under the OECD treaties, the decedent's country of domicile must give the decedent's estate a credit against its tax for the foreign estate or inheritance tax paid by the decedent on property located in the other country that that country is permitted to tax under the treaty.

(b) Continuing the above example, when a U.S. citizen and resident owns U.K. real property, the United Kingdom may impose its inheritance tax on that property. *Id.,* Articles 5(1)(a), 6(1). The United States may also impose its federal estate tax on the value of the property by virtue of the decedent's U.S. citizenship. The IRS, however, must give the estate a credit against the federal estate tax for the U.K. inheritance tax. *Id.,* Article 9(1)(a). Thus, the estate will pay the higher of the two taxes, which at this point is the U.S. federal estate tax, taking the relative exemptions from the federal estate tax and the U.K. inheritance tax into account.

(c) Some OECD treaties, however, effectively incorporate the second limitation of the IRC § 2014 credit for foreign death taxes, which means that the credit against the U.S. tax cannot exceed the ratio that the foreign property bears to the gross estate less the charitable deduction and the marital deduction. For example, the Technical Explanation of the 2004 Protocol to the United States – France Estate Tax Treaty in its discussion of the credit allowable against federal estate tax for French inheritance tax describes how this limitation works:

> Under paragraph 2(b)(iii), notwithstanding the provisions of paragraph 2(b)(i) and (ii), the total amount of all credits allowed by the United States pursuant to Article 12 or pursuant to its own laws or other conventions with respect to all property in respect of which a foreign tax credit is allowable under paragraph 2(b)(i) and (ii) (French property) is not to exceed that part of the United States tax which is attributable to such property. The part of the tax deemed to be so

attributable is to be determined in accordance with the principles of section 2014(b)(2) of the Code and section 20.2014-3 of the Estate Tax Regulations.

3. Situs Treaty Countries

a. The "situs" treaties (Australia, Finland, Greece, Ireland, Italy, Japan, Norway, and South Africa) generally provide that the following items will have a situs in a foreign country:

(i) Real property located in the foreign country

(ii) Tangible personal property located in the foreign country with an "in transit" exception. Ships and aircraft generally have a situs in the country of registration.

(iii) Shares of stock in corporations organized in the relevant foreign country.

b. The treaties vary with respect to the situs rules for:

(i) Debts of foreign obligors.

(ii) Deposits in bank accounts in treaty countries

c. Even if property has a foreign situs under the treaty, the foreign country may not tax the property under its domestic law. If so, the treaty provision that gives the country the right to tax the property is irrelevant.

d. The situs treaties' principal mechanism for the avoidance of double taxation is a credit against the U.S. federal estate tax for death taxes paid to the situs country on property deemed located in the situs country under the treaty. A credit against the federal estate tax arises when the other country taxes an asset based on its situs and the U.S. taxes the asset based on the decedent's citizenship. In effect the decedent's estate will pay the higher of the two taxes on the property in question. In contrast to the OECD treaties, the situs treaties do not offer blanket exemptions from tax for certain classes of property.

4. Special Treaty Issues

a. Australia

(i) The United States and Australia entered into a situs-style

estate tax treaty in 1953. Convention Between the Government of the United States of America and the Government of the Commonwealth of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on the Estates of Deceased Persons, TIAS 2903. Australia, however, repealed its estate tax in 1979. The treaty is not important to U.S. citizens who own Australian property because Australia does not have an estate tax.

(ii) The United States – Australia estate tax treaty, however, remains in force. *See* Treaties in Force as of January1, 2011 (U.S. Department of State)(available online at http://www.state.gov/documents/organization/169274.pdf (noting that the Australia estate tax treaty is in force).

(iii) The Australia treaty has situs rules similar to the other situs treaties, except that the treaty does not have a situs rule for corporate shares. The situs rules in the Australia treaty are quite similar to the rules under the Internal Revenue Code, so the treaty rules do not really change the property of an Australian resident decedent's estate that the United States can tax compared to U.S. domestic law. The primary benefit of the Australia treaty for estates of Australian-domiciled decedents is the pro rata credit against U.S. federal estate tax.

b. Switzerland

(i) While the United States has an estate tax treaty with Switzerland, that treaty – alone among the U.S. estate tax treaties – does not have any rules governing the situs of property for estate tax purposes. *See generally* Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Estates and Inheritances, TIAS 2316. The treaty takes this approach because inheritance taxes differ among the Swiss cantons. Thus, a comprehensive treaty was not practicable.

(ii) Under the treaty, the rules of the Internal Revenue Code apply to determine which assets of a Swiss-domiciled decedent's gross estate are situated in the United States Conversely, the situs rules of the various Swiss cantons determine what items of property of a U.S. decedent's estate will be subject to cantonal inheritance tax. To the extent that a Swiss canton imposes an inheritance tax on

the estate of a U.S. decedent, the United States must allow a credit against the federal estate tax for the cantonal tax.

c. Canada

(i) The United States and Canada entered into an estate tax treaty in 1961. Convention Between the Government of the United States of America and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on the Estates of Deceased Persons, TIAS 4995 (the "1961 Treaty"). Canada, however, repealed its estate tax in 1972.

(ii) The 1961 Treaty, however, remained in force until December 31, 1984, when Canada and the U.S. agreed to terminate the treaty. *See* Convention Between The United States of America and Canada with respect to Taxes on Income and on Capital (1980) (the "1980 Treaty"), TIAS 11087, Article 30(8) (terminating the 1961 Treaty). The reason that the 1961 Treaty continued to apply was that neither Canada nor the U.S. acted to terminate the 1961 Treaty in accordance with its provisions.

(iii) Following the termination of the 1961 Treaty, the IRS and the courts took the position that the Canadian capital gains tax at death did not qualify as a "foreign death tax" for purposes of the IRC § 2014 foreign death tax credit. *E.g., Estate of Ballard v. Commission,* 85 T.C. 300 (1985); Rev. Rul. 82-82, 1982-1 C.B. 127. Thus, the estate of a U.S. decedent could pay federal estate tax and Canadian capital gains tax on certain appreciated Canadian assets.

(iv) In 1995 Canada and the United States adopted a protocol to the 1980 Treaty that attempted to solve the double taxation problem. *See generally* Protocol Amending the Convention Between the United States of America and Canada with respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980, as Amended by the Protocols signed on June 14, 1983 and March 28, 1984 (the "Protocol").

(v) The Protocol, in connection with other parts of the treaty, offers some important benefits for estates of U.S. citizens and residents who own property subject to Canadian income tax. For example, some deemed dispositions at death that would be taxed under Canadian domestic

federal tax law are not taxable to U.S. taxpayers under the treaty. Under Section 115(1)(b) of the Canadian Income Tax Act gains from the sales or deemed dispositions of the following types of property by a nonresident of Canada are subject to Canadian income tax:

(a) Canadian real property;

(b) Stock in a non-publicly traded Canadian corporation;

(c) Stock in a Canadian publicly traded corporation more than 25 percent of which is owned by the taxpayer, or persons with whom the taxpayer did not deal at arm's length; and

(d) Interests in a partnership 50 percent or more of the value of which is attributable to certain property, primarily Canadian natural resources, timber, and real property.

Under Article 13 of the 1980 treaty, U.S. residents are generally exempt from Canadian capital gain tax on most forms of Canadian property other than real estate held directly by the resident or indirectly, such as through a Canadian corporation, partnership, trust, or estate. Thus, the treaty limits the items of property of a U.S. resident decedent to which the deemed disposition tax will apply on his or her death.

(vi) The estate of a U.S. citizen or resident decedent also may take a credit against the U.S. federal estate tax for any Canadian federal or provincial income taxes imposed at the decedent's death with respect to property situated in Canada. Protocol, Art 19(7). The amount of the credit is subject to the limitations established for the foreign death tax credit of IRC § 2014. Protocol, Art 19(7)(b).

(vii) The Protocol also may allow the estate of a U.S. citizen to defer capital gains tax until the death of the decedent's surviving spouse or common-law partner.

(a) Canadian income tax law allows a Canadian resident surviving spouse or common-law partner and certain Canadian resident testamentary trusts to defer the capital gains tax at death through a roll over. Income Tax Act § 70(6).

(b) The Protocol provides that a United States citizen and his or her spouse may be treated as Canadian residents for purposes of the spousal rollover from Canadian income tax. Protocol, Art 19(5). Accordingly, a U.S. resident's transfer of Canadian property at death to his or her non-Canadian resident surviving spouse is eligible for a rollover.

(c) Spousal rollover treatment is also available for a U.S. resident's transfer of Canadian property to a qualifying testamentary marital trust under Income Tax Act § 70(6)(b) for a non-Canadian resident surviving spouse. Protocol, Art 19(5). Income Tax Act § 70(6)(b) provides that a trust will be "qualified" for a rollover if:

(1) the trust was created by the taxpayer's will;

(2) the taxpayer's spouse or common law partner is entitled to receive all the income of the trust that arises before the spouse's or common law partner's death; and

(3) no person other than the spouse may, before the spouse's or common law partner's death, may receive or otherwise obtain the use of any of the income or capital of the trust.

Income Tax Act § 70(6)(b) also provides that the qualifying testamentary trust must be a resident of Canada "immediately after the time the property vested indefeasibly in the trust." The Protocol, however, deems a U.S. resident trust to be a Canadian resident trust for purposes of Article 19(5). The purpose of this provision is to allow transfers of Canadian property by U.S. residents (citizens and noncitizens) to qualified domestic trusts and other trusts that qualify for the federal estate tax marital deduction as transfers to qualifying spousal rollover trusts. The exemption for a U.S. resident trust, however, will be allowed only if the Canadian authorities treat the trust as a Canadian resident trust. The Protocol, however, provides no standards for the Canadian authorities to apply when considering whether a U.S. resident trust should be treated as a Canadian resident trust. As a result, it is unclear when a U.S. trust may be

deemed a Canadian resident trust for purposes of this rule. One commentator suggested that Canada might agree to treat the trust as a Canadian resident trust if the trustee posts adequate security for the payment of Canadian tax when due. Wolfe D. Goodman, "Cross-Border Estate Planning: The Canada-United States Income Tax Convention," Probate & Property, 45, 48 (July/August, 1996).

d. Austria

(a) By reason of a decision of the Austrian Constitutional Court in 2008, Austria has not levied any death duties since 2008, although since August 1, 2008, there is a modest tax on transfers of Austrian real estate received by an inheritance.

(b) The United States - Austria estate tax treaty, however, remains in force.

5. IRC § 2014 Credit

a. IRC § 2014 allows the estate of a U.S. citizen or resident to claim a credit against federal estate tax for foreign death taxes actually paid to another country with respect to property located in that country. The credit specifically applies to death taxes substantially equivalent to an estate, inheritance, legacy, or succession tax. Rev. Rul. 82-82, 1982-1 CB 127. In other words, the credit is available for those taxes imposed on the value of property transferred from a decedent to a beneficiary.

b. No credit is allowed under IRC § 2014 if the property in question subject to death tax in another country is located outside of that country under the principles of IRC § 2104 and § 2105. Thus, if a U.S. citizen's estate includes money on deposit in a Spanish bank, Spanish inheritance tax on the money would be eligible for the IRC § 2014 credit because the money would be deemed to have a situs in Spain under IRC § 2104. *Estate of Schwartz v. Commissioner*, 83 T.C. 943 (1984), *acq.* 1986-2 C.B. 1. *See also Riccio v. United States*, 71-2 U.S.T.C. ¶ 12,801 (D.P.R. 1971). *But see Borne v. United States*, 83-2 U.S.T.C. ¶ 13,536 (N.D. Ind. 1983)(reaching a conclusion opposite the conclusion in *Estate of Schwartz* with respect to a credit against federal estate tax for Ontario death taxes on money on deposit in a Canadian bank included in the estate of a U.S. citizen decedent who resided in Canada).

c. The IRC § 2014 credit for foreign death taxes is subject to two limitations.

(i) The tax credit is limited to the product of (a) the foreign death tax paid and (b) the ratio of foreign property included in the gross estate to the value of all foreign property subject to tax. This limitation has the effect of limiting the credit to the foreign tax attributable to property that is subject to both foreign and U.S. tax. For purposes of this calculation, the estate must use U.S. dollars based on the exchange rate at the time of the tax payment. Treas. Reg. § 20.2014-2(a); Rev. Rul. 75-439, 1975-2 C.B. 359.

(ii) The second limitation is the product of (a) the federal estate tax less the applicable credit and (b) the ratio of the value of foreign property subject to tax and included in the decedent's gross estate to the adjusted value of the decedent's entire gross estate. This calculation uses federal estate tax values of the foreign property.

d. An estate may choose to utilize a treaty credit or the foreign death tax credit, whichever produces a better result for the estate (usually the treaty). If the estate elects to proceed under a treaty, it must disclose its reliance on the treaty to the IRS on the federal estate tax return by filing an IRS Form 8833, which discloses information to the IRS about the treaty-based position taken by the estate. IRC § 6114; Treas. Reg. § 301.6114-1(d)(1). Failure to disclose the position may result in a $1,000 fine.

e. An estate must file an IRS Form 706-CE with the IRS to claim an IRC § 2014 foreign tax credit or a foreign tax credit under an estate tax treaty. The instructions to the form direct the executor to ask that a foreign tax official certify the form. If a foreign official will not certify the form, the executor must explain why the foreign government did not certify the form.

VIII. General U.S. Income Tax Issues for Clients Who Own Foreign Property

A. *Introduction*

1. If a U.S. citizen or resident client knows that he or she will receive a gift or bequest from a nonresident alien, careful advance planning can permit tremendous U.S. tax savings.

2. A nonresident alien of the United States is subject to limited federal gift and estate taxation. In particular, a nonresident alien is not subject to gift tax on gifts of intangible property. Thus, a nonresident alien can often

theoretically make gifts to long term or perpetual trusts for the benefit of U.S. citizens and residents with the imposition of little or no U.S. gift or estate tax. Furthermore, to the extent that a nonresident alien makes a gift or bequest to a trust that is not subject to U.S. gift tax or estate tax, then the trust will be GST exempt. The end result is a long term or perpetual GST exempt trust for the benefit of U.S. beneficiaries. U.S. citizens and residents no longer can create these kinds of trusts but nonresident aliens can. In the right circumstances, this presents a blockbuster estate planning opportunity.

3. The inheritance of property from overseas may involve a lot of wealth transfer tax savings, but it may generate numerous income tax issues for U.S. citizen and resident recipients. The tax issues have two dimensions. One dimension is the substantive income tax rules; there are many basic and complicated income tax rules for U.S. taxpayers who own foreign property. The other dimension is compliance; U.S. taxpayers who own foreign property, whether it generates income or not, often have greater compliance burdens than U.S. taxpayers who own only U.S. property.

4. The substantive income tax rules and compliance rules for U.S. clients who own foreign property can often be more complicated and more onerous than the rules and compliance obligations related to domestic investments. Clients may or may not be aware of all of their obligations. The client's professional advisers can be of great assistance in making sure that the client understands his or her tax and reporting obligations and that the client follows the rules.

B. *Reporting Worldwide Income*

1. A basic principle of U.S. income tax law is that a U.S. citizen or resident is subject to U.S. federal income tax on his or her worldwide income. Such a citizen or resident must report all of his or her income on his or her U.S. individual income tax return

2. A basic assumption of this outline is that your client tells you that he or she has foreign property. One of the first questions to ask in response is whether the client reports the income, if any, and whether the clients are filing the proper informational returns with the IRS.

3. Clients vary in their response to the question of whether they are reporting their foreign source income to the IRS. Clients usually instinctively know that they must pay U.S. income tax on their worldwide income. Sometimes, however, clients fool themselves into thinking that because the property is overseas, they do not need to pay tax on its income, particularly if the income is not brought in to the United States. Other clients may be outright tax cheats. Still other clients have heard that it is possible to avoid U.S. income taxes through the use of foreign

corporations and foreign trusts and figure that they should be able to do so too. The opportunities to defer or eliminate U.S. income tax on foreign source income, however, are few and far between.

4. It can be helpful for a U.S. tax adviser to raise the tax and compliance issues with the client from the start. If the client has been taking a *laissez faire* attitude towards U.S. tax payments, the situation will probably not improve for the client. Furthermore, the lawyer or other tax adviser will be able to quickly judge the quality of the client based on his or responses to questions about U.S. tax compliance.

C. *Disclosing Signature Authority Over Foreign Financial Accounts*

1. Federal law requires each U.S. citizen or resident to keep records of transactions and relationships with foreign financial agencies. 31 U.S.C. 5314(a). The purpose of this legislation is to give the government information that it can use "in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism." 31 U.S.C. 5311.

2. A U.S. citizen or resident for income tax purposes, as well as any "entity" formed under the laws of the United States or its principal governmental subdivisions must report bank, securities, and other financial accounts maintained in a foreign country in which the U.S. person has a financial interest *or* over which he or she has signature authority or "other authority" on FinCEN Form 114 or an "FBAR" if the value of the assets in all such accounts exceeds $10,000 at any time during the calendar year. *See* 31 CFR § 1010.350(a). Released on September 30, 2013, FinCEN Form 114 replaces Form TD 90-22.1. The form must be filed for a calendar year by June 30 of the succeeding calendar year. For purposes of the form, financial accounts in Guam, Puerto Rico, and the U.S. Virgin Islands are not considered to be foreign.

3. A U.S. person required to file an FBAR must disclose his or her foreign bank and securities accounts as well as "other financial accounts," which are the following:

   a. An account with a person that is in the business of accepting deposits as a financial agency;

   b. An account that is an insurance policy or an annuity policy with a cash value; or

   c. An account with a person that acts as a broker or dealer for futures or options transaction in any commodity on or subject to the rules of a commodity exchange or association.

The regulations also provide that a U.S. person must report an account with a "mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions." The regulations have a "Reserved" spot for further kinds of financial accounts. The regulations set forth exceptions for certain kinds of accounts. *See generally* 31 CFR § 1010.350(c)(4).

4. Under the applicable regulations, a U.S. person must file an FBAR if he or she has a *financial interest* of the following kind in a foreign bank, securities, or other financial account without regard to whether he or she has signature authority over the account:

   a. An account that he or she maintained for his or her own benefit or for the benefit of another person.

   b. An account of which he or she was a joint owner.

   c. An account that another person maintains as an agent, nominee attorney, or in some other capacity for a U.S. person.

   d. An account maintained by a corporation if the U.S. person owns more than 50% of the stock by value or voting power.

   e. An account maintained by a partnership in which the U.S. person owns more than 50% of the profits or capital of the partnership.

   f. An account maintained by a trust if the grantor is a U.S. person and is deemed to own the trust's items of income, gain, and loss under the grantor trust rules of IRC § 671-679.

   g. An account maintained by a trust if the U.S. person has a present beneficial interest, either directly or indirectly, in more than 50% of the assets or receives more than 50% of the income of the trust. The regulations misapprehend the nature of a trust. A trust is a relationship and cannot hold legal title. The trustee of the trust holds legal title. The final regulations have an exception to this rule if the trustee of the trust or agent of the trust is a U.S. person who files a report. 31 CFR §§ 1010.350 (e)(1), (e)(2), (g)(5)

5. A failure to file an FBAR can result in penalties pursuant to 31 U.S.C. § 5322(a), (b), and 18 U.S.C. § 1001. Section 1001 is a statute that generally criminalizes fraud in connection with statements to the U.S. government. Section 5322(a) states that a person who "willfully violates" any part of Title 31 or a regulation promulgated under Section 5322 "shall be fined for not more than $250,000, or imprisoned for not more than five years, or both." Section 5322(b) simply steps up the penalty when the statute is willfully violated "while violating another law of the United States or as a part of a pattern of any illegal activity…" *Id.* In addition,

31 U.S.C. § 5321 indicates that a person may face civil penalties for failing to file an FBAR, including a penalty of up to $10,000 without regard to whether the failure to file was willful. The government can waive the penalty if the person who failed to file the form reported the income from the foreign account on his or her income tax return and demonstrates reasonable cause for failure to file. *See* 31 U.S.C. § 5321(a)(5).

6. The FBAR is not a tax return, and therefore the date and place for filing is not the same as for tax returns. The due date for the FBAR is June 30 of the year following the year for which the taxpayer files the FinCEN Form 114. The June 30 date may not be extended. Taxpayers must prepare and file the FBAR electronically on the "BSA E-Filing System" website. The form itself is an easy-to-use .pdf form that has several tabs that can be filled in by the taxpayer or preparer on the website and then e-filed. A special form, FinCEN 114a, is required for taxpayers who file the FBAR jointly. Because FBARs must be filed electronically, there should be few issues with timely filing of the FBAR.

D. *Disclosing "Specified Foreign Financial Assets"*

1. In 2010 Congress added a new section, 6038D, to the Internal Revenue Code that has implications for U.S. citizen and resident shareholders in foreign corporations who are not required to file reports related to their shares under IRC § 6046 or IRC § 6038.

    a. Under IRC § 6038D, a U.S. citizen or resident taxpayer who holds "specified foreign assets" with a collective value of more than $50,000 must disclose those assets to the IRS on an annual basis. For almost all taxpayers, the filing requirement applies for 2011 and future years.

    b. The legislation defines "specified foreign assets" as accounts held at a foreign financial institution and assets held outside of a foreign financial institution, which include stock or securities issued by a non-U.S. person, a financial instrument or contract (if the contracting party is a non-U.S. person), or any interest in a foreign entity. Though the nature of the information requested is similar to that required on a Report of Foreign Bank and Financial Accounts (FBAR), this requirement does not eliminate the need for a foreign account holder to file an FBAR. This new requirement is supplementary, and broadens the disclosure requirements by applying to certain persons who may not meet the current levels of ownership to require an FBAR filing. Because the reporting threshold under this rule is value based, there will be instances in which a U.S. person may be required to file both a disclosure statement and an FBAR, and other instances in which a U.S.

person's interest may not meet the FBAR reporting threshold but may be great enough so as to require disclosure under the HIRE Act.

c. The legislation applies to interests in foreign financial assets that a U.S. taxpayer "holds," though it does not include the usual modifier "directly or indirectly." Recently issued temporary regulations take the position that a taxpayer need disclose only directly owned foreign financial assets. Temp. Treas. Reg. § 1.6038D-2T(b)(3). For this reason, a taxpayer need not separately disclose shares in a non-U.S. company held in a U.S. or a foreign financial account. Similarly, a beneficiary of a foreign trust or estate must disclose his or her interest in the trust or estate, rather than its assets. *See* Temp. Treas. Reg. § 1.6038D-3T(b)(1)(iii). If a taxpayer indirectly or constructively owns interests in a foreign corporation or foreign partnership through foreign trust or estate, however, he or she may be required to disclose his or her ownership of those interests on an IRS Form 5471, 8858, or 8865.

2. One unusual feature of IRC § 6038D and its temporary regulations is that an interest in a foreign trust is a "specified foreign financial asset" that is reportable under IRC § 6038D. Temp. Treas. Reg. §§ 1.6038D-3T(c) and -3T(d)(4)).

a. An individual will have an "interest" in a specified foreign financial asset if the holding of that asset in one way or another affects or could affect his or her income tax return during the year:

> A specified person has an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the specified foreign financial asset are or would be required to be reported, included, or otherwise reflected by the specified person on an annual return. A specified person has an interest in a specified foreign financial asset even if no income, gains, losses, deductions, credits, gross proceeds, or distributions are attributable to the holding or disposition of the specified foreign financial asset for the taxable year.

For individuals, an "annual return" for this purpose means an income tax return and not an informational return, such as an IRS Form 3520. Therefore, this definition appears to not cover interests in foreign grantor trusts because the receipt of a distribution from such a trust will not affect a beneficiary's U.S. income tax return for the year of the distribution, even though the beneficiary must report the distribution to the IRS on a form 3520.

b. A beneficiary of a foreign trust may or may not know whether he or she has an "interest" in the trust. The temporary regulations provide that if a U.S. citizen or resident does not know that he or she has an interest in a discretionary trust, he or she is not required to report the interest on Form 8938. Temp. Treas. Reg. 1.6038D-3T(c) (an interest in a foreign trust is not a reportable foreign financial asset unless the person "knows or has reason to know based on readily accessible information of the interest"). If a U.S. citizen or resident beneficiary knows of the interest, the temporary regulations in effect provide that the value of that interest in the trust for a given year is the sum of the distributions from the trust to the beneficiary for that year. *See* Temp. Treas. Reg. § 1.6038D-5T(f)(2)(i)(A).

c. These new rules raise the question of how to value an interest in a trust, which is something of a novel exercise in U.S. tax law. Valuing an interest in a trust is important for two reasons:

(i) To determine whether the taxpayer's collective foreign financial assets meet the Form 8938 filing threshold; and

(ii) To determine the value of an interest in a trust for purposes of completing Form 8938.

d. If the beneficiary receives a distribution from a foreign discretionary trust, he or she must disclose the receipt of that distribution to the IRS on an IRS Form 3520. *See* IRC § 6048(c). The beneficiary may or may not be required to also disclose the interest in the trust on a Form 8938. Such a disclosure will be required only if the beneficiary meets the filing threshold.

e. If the beneficiary received no distributions from a discretionary trust in a particular year, under the temporary regulations the beneficiary may value his or her beneficial interest in the trust at zero for purposes of determining whether he or she meets the filing threshold for that year. Because the temporary regulations tie the maximum value of an interest in a discretionary trust to the distributions from the trust, it appears that even if the beneficiary knows of the existence of the interest but has not received any distributions in that tax year, he or she does not have to disclose the interest on Form 8938 for that tax year if the beneficiary otherwise must file the form for that tax year.

f. If a U.S. citizen or resident's only beneficial interest in a foreign trust is a right to receive mandatory distributions from the trust, such as distributions of income, the maximum value of the person's interest in the trust is its actuarial value under IRC §

7520. Temp. Treas. Reg. § 1.6038D-5T(f)(2)(i)(B). In essence, IRC § 7520 directs a taxpayer to value income interests, remainders, and reversions based on actuarial tables that have factors tied to an IRS-assumed interest rate that changes on a monthly basis. The IRC § 7520 interest rate for March 2012, for example, was 1.4%, which means that the actuarial value of a 35-year old's life income interest in a trust with $1 million of assets is $444,510. The tables are unisex; they make no differentiation between men and women. Only rarely do the tables not apply to the valuation of "mandatory" interests.

g. The temporary regulations assume that a beneficiary of a trust from which he or she has a right to receive mandatory distributions knows the value of the principal of the trust and the nature of his or her interest in the trust. The temporary regulations do not address a situation in which a beneficiary of such a trust knows of his or her interest but lacks information to compute the value of that interest, such as the value of the trust capital, the nature of other beneficial interests, and all of the relevant terms of the trust deed. This probably reflects the bias of the regulation writers toward a U.S. model of trust administration in which most trustees of mandatory income trusts provide thorough accountings on an annual basis and most beneficiaries have copies of the trust instruments. It may be that comments on these temporary regulations point out the different way foreign trusts are administered in an attempt to modify this rule. At a minimum, the beneficiary will know what distributions he or she received in a year, so absent any other information that is the starting point for reporting.

h. The value of a person's beneficial interest in a trust in which he or she has a mandatory income and discretionary capital interest is the sum of the actuarial value of the income interest and the amount of the distributions to him or her during the reporting year.

3. The IRS recently issued a new form, Form 8938, by which taxpayers can comply with IRC § 6038D. A $10,000 penalty will apply to a taxpayer who fails to timely file an IRS Form 8938. An additional $10,000 penalty is due for every 30 days the failure to file persists longer than 90 days after the taxpayer is informed of such failure, up to a maximum penalty of $50,000.

IX. General Issues for U.S. Owners of Shares in Foreign Corporations

A. *Tax Rate on Dividends*

1. If a foreign corporation is a "qualified foreign corporation," dividends

paid by the corporation to a U.S. shareholder will qualify for the 15% federal income tax rate on dividends. A corporation will be a qualified foreign corporation if its shares are readily tradable on an established U.S. securities market. IRC § 1(h)(11)(C)(ii). A corporation will qualify if ADRs in its shares or the shares themselves are readily tradable. The markets that qualify are the Nasdaq, NYSE, AMEX, Boston Stock Exchange, Chicago Stock Exchange, Philadelphia Stock Exchange, Cincinnati Stock Exchange, and the Pacific Exchange, Inc. IRS Notice 2003-71, 2003-43 I.R.B. 922. The IRS stated in Notice 2003-71 that the OTC Bulletin Board and the pink sheets did not meet the definition of an established U.S. securities market, although the IRS said it would consider expanding the definition of such a market in the future.

2. A corporation will be a "qualified foreign corporation" if the corporation is eligible for the benefits of a comprehensive income tax treaty with the United States. IRC § 1(h)(11)(C)(i)(II). The treaty must also have an information exchange provision. The IRS originally listed the U.S. income tax treaties that are "comprehensive" for purposes of IRC § 1(h)(11)(C) in IRS Notice 2003-69, 2003-42 I.R.B. 851. The IRS supplemented the list in 2006 in IRS Notice 2006-101, 2006-47 I.R.B. 930. Even if the corporation is incorporated within one of these countries, it must still qualify for benefits under the treaty, which is a separate inquiry.

B. *Reporting the Acquisition of Shares*

1. Under IRC § 6046(a)(1)(B), a U.S. taxpayer must report the acquisition of shares in a foreign corporation to the IRS on Form 5471 in two situations:

    a. When the taxpayer acquires shares in a foreign corporation which, when added to the shares the taxpayer already owns, results in the taxpayer owning 10% or more of the total combined voting power of all classes of stock of the corporation entitled to vote or 10% or more of the total value of the corporation. IRC §§ 6046(a)(1)(B)(i), 6046(a)(2).

    b. When the taxpayer acquires shares in a foreign corporation which, without regard to the shares the taxpayer already owns, results in the taxpayer owning 10% or more of the total combined voting power of all classes of stock of the corporation entitled to vote or 10% or more of the total value of the corporation. IRC §§ 6046(a)(1)(B)(ii), 6046(a)(2).

2. The reporting requirement of IRC § 6046(a) applies if the U.S. taxpayer owns stock directly or indirectly. Under IRC § 6046(c), an individual will be deemed to indirectly own shares owned by members of his or her family. "Family" for this purpose means "only brothers and sisters

(whether by the whole or half blood), spouse, ancestors, and lineal descendants." IRC § 6046(c). This is the only instance in the Code in which there is sibling-to-sibling attribution, and it is to no particular purpose; neither the CFC constructive ownership nor the PFIC indirect ownership rules have sibling-to-sibling attribution. To this extent, the constructive ownership rules do not really help the government monitor the proper application of the CFC or PFIC rules. This family attribution rule does not apply to treat a U.S. person as indirectly owning shares deemed to be indirectly owned by another U.S. member of that person's family. Treas. Reg. § 1.6046-1(i)(2).

3. The reporting requirements apparently do not apply if a U.S. person becomes a beneficiary of a foreign trust or foreign estate that owns shares in a foreign corporation. Any reporting requirements related to the acquisition of shares are postponed until the U.S. taxpayer receives a distribution of shares from such a trust or estate. *See* Treas. Reg. § 1.6046-1(i)(1)(only shares owned by a corporation or partnership will be deemed to be indirectly owned by shareholders or partners; no reference to estates or trusts).

4. A U.S. taxpayer subject to the reporting requirements is a "Category 3" filer for IRS Form 5471 purposes. The Instructions to Form 5471 provide that a putative Category 3 filer does not have to file Form 5471 if all the following apply:

   a. The U.S. taxpayer does not directly own any shares in the foreign corporation.

   b. The filing requirement arises solely because the U.S. taxpayer constructively owns shares owned by another U.S. taxpayer.

   c. The U.S. person through whom the putative Category 3 filer owns shares files an IRS Form 5471 with all of the required information.

   See Treas. Reg. § 1.6046-1(e)(4)(iii).

C. *Information Filing for "Control" Shareholders*

1. Any U.S. person who "controls" a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the corporation must file an IRS Form 5471. *See* IRC § 6038(a)(1); Treas. Reg. § 1.6038-2(a)(2). Such a person is a "Category 4" filer for Form 5471 purposes.

2. "Control" for IRC § 6038 purposes means ownership of stock that possesses more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the value of shares of all classes of stock in the corporation. IRC § 6038(e)(2); Treas. Reg. §

1.6038-2(b). Note that the corporation in question does not need to be a controlled foreign corporation or "CFC" for U.S. tax purposes. A foreign corporation for which a U.S. person meets the "control" test of IRC § 6038(e)(2) will be a CFC only if there are one or more U.S. shareholders who control 10% or more of the vote of the corporation. *See* IRC § 951(b). Under IRC § 6038(e)(2), it is possible that a U.S. person could be deemed to "control" a foreign corporation by owning more than 50% of the value of the shares of the corporation. Unless another U.S. person controls 10% or more of the vote, however, the corporation will not be a CFC.

3. In determining whether a U.S. taxpayer "controls" a corporation for IRC § 6038 purposes, the constructive ownership rules of IRC § 318(a) apply. Treas. Reg. § 1.6038-2(c).

4. A putative Category 4 filer is not required to file an IRS Form 5471 if the person is deemed to control a foreign corporation only because he or she is deemed to constructively own shares owned by a nonresident alien. This exception does not apply if the U.S. shareholder directly or indirectly owns any shares of the foreign corporation. Treas. Reg. § 1.6038-2(l).

5. In addition, a putative Category 4 filer does not have to file Form 5471 if all the following apply:

   a. The U.S. taxpayer does not directly own any shares in the foreign corporation.

   b. The filing requirement arises solely because the U.S. taxpayer constructively owns shares owned by another U.S. taxpayer.

   c. The U.S. person through whom the putative Category 4 filer owns shares files an IRS Form 5471 with all of the required information.

   See Treas. Reg. § 1.6038-2(j)(2).

X. Controlled Foreign Corporations and Foreign Trusts and Foreign Estates

A. *CFC Basics*

1. If a US taxpayer owns shares in a controlled foreign corporation or "CFC," the taxpayer will have special compliance obligations and substantive tax issues as a result of the ownership of those shares. These tax issues may arise when a U.S. taxpayer is the beneficiary of a foreign estate or a foreign trust that owns shares in a foreign corporation.

2. A foreign corporation is a CFC if on any day during its tax year one or more United States shareholders directly, indirectly, or constructively own more than 50% of the total combined voting power of all classes of the

foreign corporation's voting stock or more than 50% of the total value of the foreign corporation's stock. IRC § 957(a); Treas. Reg. § 1.957-1(a). For purposes of the CFC rules, a United States shareholder is a "United States person" who "owns . . . or is considered as owning" 10% or more of the total combined voting power of all classes of stock entitled to vote. IRC § 951(b).

3. For a foreign corporation to be a CFC, the following facts must be present:

    a. One or more U.S. taxpayers must own 10% or more of the total combined voting power of all classes of stock entitled to vote. IRC § 951(b).

    b. The 10% U.S. shareholders must collectively own more than 50% of the total combined voting power of the corporation's outstanding stock or more than 50% of the total value of the stock of the corporation. IRC § 957(a).

    If both facts exist, the corporation is a CFC. If either one of the facts is not true, the corporation is not a CFC.

4. If the corporation is a CFC, the next step is to determine the extent to which the CFC's U.S. shareholders are currently subject to U.S. income tax on the corporation's Subpart F income.

    a. Each 10% U.S. shareholder of a CFC is subject to U.S. income tax on the shareholder's proportionate share of the CFC's "Subpart F" income, which, broadly speaking, is income from the CFC's non-operating or passive assets. IRC § 951(a). *See generally* IRC § 952(a).

    b. For this purpose, the shareholder's "proportionate share" of the CFC includes not only the shareholder's voting shares but also the shareholder's nonvoting shares. A U.S. shareholder who owns less than 10% of the voting power of a CFC is not subject to tax on his or her pro rata share of the CFC's Subpart F income even if the shareholder owns more than 10% of the value of the CFC's shares due to his or her ownership of nonvoting shares. *See* IRC §§ 951(a), 951(b).

5. Income tax consequences of CFC share ownership.

    a. Any U.S. taxpayer who is a 10% shareholder of a CFC must include a pro-rata share of the CFC's Subpart F income in his or her income whether or not the CFC distributes that income. Subpart F income is effectively taxed as dividend income that does not qualify for the 15% federal rate on qualified dividends. This characterization applies regardless of the source of the Subpart F

income, including realized gains. A U.S. taxpayer will have Subpart F income only if the corporation has earnings and profits in the relevant calendar year, computed using U.S. tax principles.

b. A CFC's non-Subpart F income is not taxed to a shareholder until the CFC distributes that income to a shareholder. The shareholder will pay tax on that distributed income under normal U.S. principles. Most importantly, the distribution will be taxed as a dividend to the shareholder if the corporation has earnings and profits in the year of distribution, but taking any previously taxed Subpart F Income into account. Such a distribution is eligible for the 15% rate on dividends provided that the corporation is a "qualified foreign corporation" under IRC § 1(h)(11)(C). IRS Notice 2004-70, 2004-44 I.R.B. 724, 726.

c. If a U.S. shareholder of a CFC sells his or her shares, the gain on the sale will be treated as ordinary income to the extent of the CFC's earnings and profits over the shareholder's holding period. *See generally* IRC § 1248. Recall that in this context a "U.S. shareholder" is a person who owns 10% or more of the shares of the company either directly or indirectly. *See* IRC § 1248(a)(2)(referring to the direct and indirect ownership rules of IRC § 958(a)). The previous allocation of Subpart F income to the shareholder, however, will have increased his or her basis in the shares, resulting only in the taxation of earnings and profits only once. Furthermore, amounts treated as dividends under IRC § 1248(a) are eligible for the 15% rate on dividends, assuming that the CFC is a "qualified foreign corporation" under IRC § 1(h)(11)(C). *See* IRS Notice 2004-70, 2004-44 I.R.B. 724, 726. The special tax treatment of sales proceeds under IRC § 1248 does not apply to a redemption of shares taxed under IRC § 303. IRC § 1248(g)(1).

6. A U.S. taxpayer can own shares in a CFC directly, indirectly, or constructively.

a. Direct ownership by an individual is when the individual owns shares in his or her individual name. IRC § 958(a)(1).

b. If a U.S. taxpayer has an interest in a foreign corporation, foreign partnership, foreign estate, or foreign trust that owns shares in a foreign corporation, the taxpayer will be deemed to "indirectly" own a proportionate share of the foreign entity's shares in the foreign corporation. IRC § 958(a)(2).

c. A U.S. taxpayer will also be deemed to constructively own shares owned by other persons under the constructive ownership rules of IRC § 318(a). IRC § 958(b).

d. The indirect and constructive ownership rules can result in a U.S. beneficiary of a foreign estate or foreign trust being deemed to own shares of a foreign corporation owned by that foreign estate or foreign trust. If so, the U.S. beneficiary may have extra compliance obligations and possibly extra tax obligations.

B. *Introduction to Indirect Ownership*

1. In IRC § 958(a)(2) Congress provided that U.S. taxpayers who have interests in certain foreign entities that own shares in foreign corporations will be deemed to indirectly own the foreign entity's shares for purposes of determining whether the foreign corporation is a CFC:

> For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

2. The Treasury Regulations provide that the determination of a beneficiary's "proportionate interest" in a foreign entity, including a foreign trust, depends on the facts and circumstances of the situation:

> The determination of a person's proportionate interest in a foreign corporation, foreign partnership, foreign trust, or foreign estate will be made on the basis of all the facts and circumstances in each case. Generally, in determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) and this section are being applied will be taken into account.

Treas. Reg. § 1.958-1(c)(2).

C. *Indirect Ownership Through Foreign Estates*

1. Under the indirect ownership rule of IRC § 958(a)(2), the determination of a beneficiary's "proportionate interest" in a foreign estate depends on the facts and circumstances of the situation. Treas. Reg. § 1.958-1(c)(2).

2. The CFC indirect ownership regulations have one example that addresses beneficiaries of a foreign estate:

> Example 4. Among the assets of foreign estate W are Blackacre and a block of stock, consisting of 75 percent of the one class of stock of foreign corporation T. Under the terms of the will governing estate W, Blackacre is left to G, a nonresident alien, for life, remainder to H, a nonresident alien, and the block of stock is left to United States person K. By the application of this section, K is considered to own the 75 percent of the stock of T Corporation, and G and H are not considered to own any of such stock.

Treas. Reg. § 1.958-1(d), Example 4.

3. Applying these principles to determine the indirect ownership of a foreign estate's U.S. beneficiaries in shares of a foreign corporation should be relatively straightforward because the facts and circumstances of an estate and its beneficiaries are usually fairly simple. On the death of a decedent, the beneficiaries' interests in the decedent's estate will vest, which would appear to permit the easy application of the indirect ownership test. Thus, if a beneficiary receives a specific gift of CFC shares, he or she should be treated as indirectly owning those shares until the estate distributes the shares to him or her. *See* Treas. Reg. § 1.958-1(d), Example 4. The beneficiaries of the residue of the decedent's estate should similarly be deemed to own the estate's shares in a foreign corporation based on their proportionate interests in the residue. *Id.* Unlike trusts, estates do not raise difficult issues related to apportionment of trust property between income and remainder beneficiaries and the quantification of beneficiaries' rights in discretionary trusts.

4. Attributing ownership of a foreign estate's CFC shares to an estate's beneficiaries will be more difficult when the beneficiaries are entitled to a formula pecuniary gift or a fractional share of the estate. Unlike a specific gift of CFC shares or a fixed portion of the residue of an estate, the proportion of an estate attributable to a beneficiary of pecuniary gift or fractional gift may not be determinable until well into the administration of the estate. A pecuniary gift, for example, might abate or might be subject to the payment of estate taxes. Similarly, a gift of a fraction of the residue of an estate may be subject to the payment of specific gifts, pecuniary gifts, and some taxes and expenses. The uncertainties as to amounts, and uncertainties as to funding, at first glance appear to make the application of the indirect ownership rule to a foreign estate a problematic task. In this case, an analogy to the separate share rule of IRC § 663(c) may be the best way to proceed, although applying that rule is not necessarily easy.

D. *Indirect Ownership Through Foreign Trusts*

1. Congress did not provide any rules in the Code for determining when a U.S. beneficiary of a foreign trust would be deemed to indirectly own the trust's shares of a foreign corporation under IRC § 958(a)(2).

2. The Treasury Regulations under IRC § 958(a)(2) have one example of how to apply this facts and circumstances test in the context of a foreign trust and its beneficiaries:

> Example 3. Foreign trust Z was created for the benefit of United States persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E, and F is considered to own 30 percent (1/3 of 90 percent) of the stock in S Corporation.

   Treas. Reg. § 1.958-1(d), Example 3.

3. This example is confusing because it does not specify whether it relates to the determination of whether U.S. beneficiaries indirectly own 10% of the voting power of the corporation, indirectly own more than 50% of the voting power of the corporation, indirectly own more than 50% of the voting value of the stock, or are subject to tax on the corporation's Subpart F income as a result of their indirect share ownership.

4. The only statement from the IRS on how to apply the facts and circumstances test of IRC § 958(a)(2) to trusts other than Example (3) is FSA 199952014 (September 23, 1999). In the FSA, the IRS National Office addressed the application of the indirect ownership rules to a trust that provided that all net income was to be paid to one of two beneficiaries during the primary beneficiary's lifetime. The principal issue was whether the actuarial values of the trust beneficiaries' interests were appropriate "facts and circumstances" under to determine whether the trust's income beneficiaries were indirect shareholders. The National Office concluded that the actuarial values of the trust beneficiaries' interests were not relevant facts and circumstances for purposes of applying the indirect ownership rules. Instead, the National Office advised the field that it should treat the income beneficiaries as the owners of the trust's shares.

5. Example (3) and the FSA overlook the issue that is at the heart of the CFC rules: does a U.S. beneficiary control any voting power over with respect to the trust's shares in the foreign corporation?

   a. Under IRC § 957(a), which defines a "controlled foreign corporation," the threshold question in determining whether a foreign corporation is a CFC is whether one or more U.S. taxpayers control "10% or more of the total combined voting power of all classes of stock entitled to vote." *See* IRC § 951(b (defining "United States Shareholder")). Without at least one such U.S. shareholder, a foreign corporation cannot be a CFC. Furthermore, only a 10% shareholder is subject to tax on a CFC's Subpart F income.

   b. Example (3) and FSA 199952014 focus on who receives the current benefit of a trust's investments as the facts relevant to determining indirect ownership in the trust context. But who receives the economic benefit of the trust's investments does not tell you whether any U.S. person controls 10% or more of the voting power of a foreign corporation in which the trust owns shares.

   c. By overlooking whether a beneficiary possesses voting power over a trust's shares, Example (3) and FSA 199952014 ignore the plain language of IRC § 951(a)'s definition of a U.S. shareholder. Thus, Example (3) and the FSA are not faithful to the Congressional purpose of subjecting only those U.S. taxpayers who have some influence over control the corporation in which a foreign trust owns shares.

   d. The Tax Court has recognized the importance of determining whether U.S. shareholders actually exercise control in applying statutes such as the CFC rules. In *Estate of Miller v. Commissioner*, 43 T.C. 760 (1965), the Tax Court rejected an IRS attempt to classify a foreign corporation as a personal holding company when no U.S. persons actually controlled how the corporation was managed even though the corporation technically met the definition of a foreign personal holding company:

   > Respondent's interpretation can, as in the instant case, cause the U.S. stockholders to be subject to the tax because the corporation will not distribute, when they do not control the corporation, and they are not related to the foreign controlling stockholders nor their U.S. relative. *It is unreasonable and absurd to try to force corporate action without being able to bring pressure on those who control the corporation's actions. Alvord* v. *Commissioner, supra.*

When there is an interpretation that accords with the purpose of the act then the statute should not be interpreted to produce absurd consequences even though such an interpretation might be within the literal language of the act. *United States* v. *Amer. Trucking Ass'ns*, 310 U.S. 534. This rule of statutory construction has been applied directly to the foreign personal holding company statute. *Alvord* v. *Commissioner, supra; Marsman* v. *Commissioner, supra*. In the last cited case the court held that only that portion of the foreign personal holding company income earned by the company after the taxpayer became a U.S. resident was taxable, the opinion stating: "We do not think * * * that the statute should be applied literally and without reference to the purpose for which it was admittedly enacted." (emphasis added).

e. Consistent with the purposes of the CFC rules and the common sense approach used by the Tax Court in *Estate of Miller*, the test of whether a trust beneficiary indirectly owns a trust's shares in a foreign corporation should focus first on the extent to which the beneficiary can control or influence the voting of the shares. *See* Treas. Reg. § 1.958-1(c)(2). Factors the IRS could consider include:

   (i) Is the beneficiary acting as trustee or in another capacity in which she has the ability to vote the shares?

   (ii) If the beneficiary can vote the shares, is she acting in a fiduciary capacity when she votes the shares or does the trust instrument limit her discretion in voting the shares?

   (iii) If the beneficiary cannot vote the shares, can she control the identity of the fiduciary that votes the shares in such a way as to justify the IRS treating the beneficiary as if she can vote the shares?

f. If the trust is the only owner of the shares and the U.S. beneficiaries do not have any ability to control or influence the voting of the trust's shares, then the corporation should not be a CFC. If the corporation is not a CFC, whether or not those beneficiaries receive some benefit from the trust's use of the foreign corporation is irrelevant to the CFC rules. The beneficiaries, however, may be subject to the PFIC rules, discussed below, if the corporation is not a CFC.

g. If a foreign trust owns more than 10% of the shares of a foreign corporation and a U.S. beneficiary has the ability to vote the shares

or influence the voting of the shares, then several additional inquiries must be made to determine whether that U.S. beneficiary is in fact a 10% shareholder.

(i) Is the beneficiary an income beneficiary or a remainder beneficiary? If the beneficiary is only a remainder beneficiary, Example (3) and FSA 199952014 suggest that the beneficiary should not be treated as an indirect owner of the shares because he or she cannot presently benefit from the shares.

(ii) If the beneficiary is an income beneficiary, what percentage of the income is he or she entitled to receive? If the trust is a 25% shareholder in a foreign corporation but the beneficiary is one of five income beneficiaries, he or she should not be a 10% shareholder because he or she is entitled to only 5% of the income. On the other hand, if the trust owns 100% of the shares, the beneficiary would be a 20% shareholder. Keep in mind that the shareholder will be deemed to constructively own any shares directly or indirectly owned by a parent, spouse, or descendant under the constructive ownership rules (of which more later).

(iii) If the trust is a discretionary trust, does the beneficiary have any ability to control the amount of distributions the trustee makes to him or her? If the beneficiary has no ability to control the distribution of income from the trust, he or she should not be treated as an indirect owner of the shares because he or she cannot control whether he or she receives any benefit from the shares. The inquiry here would be similar to the inquiry as to whether the beneficiary can control the voting of the shares.

(iv) It may be appropriate to deem a U.S. person to indirectly own shares in a discretionary trust if the shares held by the trust would includable in the U.S. person's gross estate. The IRS relies on this approach in the indirect ownership rules that apply to trusts under IRC § 2701. *See* Treas. Reg. § 25.2701-1(b)(2)(C)(2).

6. If a foreign corporation has at least one 10% U.S. shareholder, then the next inquiry is whether that shareholder and the other 10% shareholders, if any, collectively control more than 50% of the voting power of the foreign corporation or collectively own more than 50% of the value of the foreign corporation. If the answer is yes, then the corporation is a CFC.

a. In the trust context, you will get to this question only if you have concluded that a U.S. trust beneficiary controls 10% or more of the voting power of the foreign corporation.

b. The question then becomes whether the beneficiary and any other 10% shareholders collectively own more than 50% of the voting power or 50% of the value of the foreign corporation directly, indirectly, or constructively.

c. If the trust in question has other beneficiaries who are related to the voting beneficiary, the voting beneficiary may be deemed to constructively own those other beneficiaries' shares, which could push ownership above the 50% level.

7. If the foreign corporation is a CFC, then the next step is to determine the extent to which trust beneficiaries are subject to current income tax on the CFC's Subpart F income.

a. Only the 10% beneficiary-owner will be subject to tax on the CFC's Subpart F income. Any shares he or she constructively owns are not counted for purposes of determining the beneficiary-owner's share of Subpart F income.

b. As noted above, the scant authority from the government on these questions focuses on the beneficiary's share of the trust income, which makes sense.

(i) The purpose of the CFC rules is to currently tax the Subpart F income of a controlled foreign corporation to those U.S. taxpayers who are shareholders and who can influence the corporation's distribution policy. Just as the CFC rules follow dividends to determine indirect ownership through a corporation, the CFC rules should follow trust distributions to determine who the indirect owners of the trust's shares are. *See* Treas. Reg. § 1.958-1(c)(2).

(ii) As is the case with corporations, trusts confer their present economic benefits through distributions. In the case of corporations, the distributions are made to the shareholders – the owners of the company. In the case of trusts, the distributions of corporate dividends are made to income beneficiaries – the equitable owners of the trust property.

(iii) The government's eschewal of actuarial factors in determining trust beneficiaries' stock indirect ownership for Subpart F inclusion purposes is consistent with the government's focus on the income beneficiaries in Example (3) in the regulations and in FSA 199952014.

Using actuarial factors would lead to remainder beneficiaries being deemed to own some of the economic benefits of the CFC. That conclusion, however, is inconsistent with the principle that Subpart F inclusion should follow the trust beneficiaries' interests in the income of the CFC, at least when the trust has a mandatory income interest.

c. The determination of who receives the economic benefits of a trust for Subpart F inclusion purposes is relatively straightforward in the case of a trust with mandatory income distributions to U.S. beneficiaries. In this situation, it is easy to determine who is receiving the economic benefits of the trust, as is the case in Example (3). Those beneficiaries would then be deemed to be the indirect owners of the CFC's shares for Subpart F income inclusion purposes.

d. It may appear inconsistent with Subchapter J to subject a trust's income beneficiary to tax on a trust-owned CFC's income when the beneficiary did not receive a distribution of any of that income. Recall, however, that you will only get to this point if you have determined that the U.S. beneficiary in question exercises some degree of control over the voting of the CFC shares If so, the imposition of tax seems less unfair. Furthermore, under the CFC rules only an income or unitrust beneficiary with an indirect interest in more than 10% of the CFC will be subject to this tax. Thus, if the foreign trust owns 25% of the CFC but the income beneficiary is only beneficiary of one-fourth of the income of the trust, then he or she will own only 6.25% of the income, making him or her a less than 10% shareholder.

8. The IRS's focus on the income beneficiaries of a trust in the application of IRC § 958(a)(2), while easy to understand, is usually unrealistic in the foreign trust context.

a. As discussed above, the IRS relies on the identity of the income beneficiaries to determine indirect ownership percentages for purposes of the CFC definitional test and the allocation of Subpart F income. The IRS appears also to rely on the identity of the income beneficiaries for 10% owner identification purposes, but as discussed above, the IRS's reasoning misses the point about control.

b. The IRS's focus on income beneficiaries assumes that every trust will have identifiable income beneficiaries. This may be true for certain foreign trusts, such as a trust in which a beneficiary has an interest in possession (a U.K. tax law concept) or a spousal

rollover trust under Canadian tax law. Most foreign trusts, however, are discretionary trusts that give the trustee wide discretion over when and to whom to distribute trust income. This is particularly true of trusts settled and administered in tax havens. If a trustee has discretion to determine to whom to distribute trust income, then how do you determine who the income beneficiaries are from time to time for purposes of applying the indirect ownership rules?

c. The IRS has not issued any public or private guidance on how to apply the facts and circumstances test of IRC § 958(a)(2) to determine the proportionate ownership of beneficiaries of a discretionary trust. Attempting to determine what facts and circumstances are relevant in this situation is usually an academic exercise because a foreign discretionary trust will probably not have any U.S. shareholders who can vote 10% or more the trust's shares in a foreign corporation, making the analysis of the trust beneficiaries' indirect ownership interests in the trust irrelevant. Most foreign trusts have non-U.S. fiduciaries who can control the voting of the trust's shares and the distributions to the beneficiaries.

d. But for the sake of argument, are there any analogous areas of the tax law in which there is authority on how to apply the proportionate ownership test of IRC § 958(a)(2)?

(i) One possibility is the rules for determining the net worth of an expatriate under IRC § 877, which applies to individuals who expatriated before June 17, 2008 (other rules apply to individuals who expatriate after June 16, 2008).

(a) Under IRC § 877, if a U.S. citizen who had a net worth of $2 million or more expatriated before June 17, 2008, he or she would have been subject to a special expatriate tax regime for the 10 years following expatriation. *See* IRC § 877(a)(2)(B) ($2 million threshold). The special tax regime also applied to certain former long term residents who gave up their green cards. *See generally* IRC § 877(e).

(b) For purposes of computing the individual's net worth, the IRS in Notice 97-19, 1997-1 C.B. 394, came up with the following method for computing the value of the individual's interest in trusts:

> The value of an individual's beneficial interest in a trust will be determined using a two-step process. First, all interests in property held by the trust must be allocated to beneficiaries (or potential beneficiaries) of the trust based on all relevant facts and circumstances, including the terms of the trust instrument, letter of wishes (and any similar document), historical patterns of trust distributions, and any functions performed by a trust protector or similar advisor. Interests in property held by the trust that cannot be allocated based on the factors described in the previous sentence shall be allocated to the beneficiaries of the trust under the principles of intestate succession (determined by reference to the settlor's intestacy) as contained in the Uniform Probate Code, as amended. Second, interests in property held by a trust that are allocated to the expatriate must be valued under the principles of section 2512 and the regulations thereunder without regard to any prohibitions or restrictions on such interest.

(c) This approach to valuing trust interests is not relevant to IRC § 958(a)(2) because the approach computes the value of all beneficial interests, including remainder interests. As discussed above, however, the IRS has taken the view that only the current beneficiaries of a trust should be considered to proportionately own shares of foreign corporations owned by the trust. Using the Notice 97-19 approach would be inconsistent with this view. The purpose of the net worth test of IRC § 877 was to determine which expatriates should be subject to the special expatriation tax regime. Whether the beneficiary has a present interest or a future interest in a trust is irrelevant for purposes of IRC § 877; Congress was concerned with persons with a certain level of wealth. With IRC § 958(a)(2), on the other hand, the government tries to determine which of the current beneficiaries should be deemed to be the owners of the trust's

shares because they are receiving the benefits of the deferral afforded through the use of the foreign corporation.

(ii) Another possible approach is the "maximum exercise of discretion" standard used in the indirect ownership rules under IRC § 2701.

(a) Under IRC § 2701(e)(3), for purposes of the special valuation rules of IRC § 2701, an individual will be deemed to indirectly own an interest in a corporation or partnership that is owned by a trust.

(b) In the regulations interpreting the indirect ownership rule, the IRS adopted a "maximum exercise of discretion" standard in determining when an individual indirectly owns an interest in a trust for purposes of IRC § 2701:

> A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust, including the income therefrom or the proceeds from the disposition thereof, is not considered the holder of the equity interest. Thus, if stock held by a decedent's estate has been specifically bequeathed to one beneficiary and the residue of the estate has been bequeathed to other beneficiaries, the stock is considered held only by the beneficiary to whom it was specifically bequeathed. However, any person who may receive distributions from a trust is considered to hold an equity interest held by the trust if the distributions may be made from current or accumulated income from or the proceeds from the disposition of the equity interest, even though under the terms of the trust the interest can never be distributed to that person. This paragraph

applies to any entity that is not classified as a corporation, an association taxable as a corporation, or a partnership for federal income tax purposes.

Treas. Reg. § 25.2701-6(a)(4)(i).

(c) The Treasury Regulations, however, provide that the government will apply the indirect ownership rule to value transactions under IRC § 2701 only when the trust beneficiary is either the owner of the trust's income and gains under the grantor trust rules or if the trust assets would be includable in the individual's gross estate. This effectively limits the application of the indirect ownership rules to situations in which a trust beneficiary has some level of control over the trust assets. The government will not apply the indirect ownership rules to cause a beneficiary to be subject to the special valuation rules if the beneficiary is not a grantor of the trust or does not have sufficient powers over the trust to cause the inclusion of its assets in the beneficiary's estate. *See* Treas. Reg. § 25.2701-1(b)(i)(C). For this reason, the "maximum exercise of discretion" test in the regulations under IRC § 2701 is not particularly helpful for determining indirect *economic* ownership, which is the key task under IRC § 958(a)(2) with respect to determining a U.S. shareholder's percentage of the value of a foreign corporation. Rather, the IRC § 2701 indirect ownership rules focus on control.

(d) Apart from the fact that the IRC § 2701 indirect ownership regulations have a fairly limited application, the maximum exercise of discretion test articulated in those regulations would not be appropriate for IRC § 958(a)(2) purposes. The purpose of the CFC indirect ownership rules is to prevent a U.S. taxpayer from deferring U.S. federal income tax on assets he or she controls and enjoys. The maximum exercise of discretion test, however, does not address whether a trust beneficiary actually benefits from a trust's ownership of shares in a foreign corporation. The government should apply the indirect ownership rules only if it prevents a deferral of tax that would otherwise be paid absent the trust and foreign corporate structure.

(iii) Another possible analogy is to the rules of IRC § 267(c).

(a) Under IRC § 267(c)(1), an interest owned by an estate or trust will be considered as owned proportionately by its beneficiaries. The IRS, however, has not issued any regulations under IRC § 267(c)(1) that explain how to apply the proportionate ownership rule.

(b) Court decisions and rulings under IRC § 267(c) do not provide any guidance on how to apply the proportionate ownership rule. In PLR 9015055, for instance, the IRS ruled that an individual and her children, who were beneficiaries of a trust that owned shares, were deemed to own the shares under IRC § 267(c)(1). The IRS, however, did not discuss how to apportion the shares among the trust beneficiaries. *See also Liflans Corp. v. United States*, 390 F.2d 695 (Ct. Claims 1968) (court concludes that beneficiaries of a trust deemed to own trust's shares under IRC § 267(c) without any discussion of the basis on which the proportionate ownership rules were to be applied); PLR 8128073. About the most we can tell from the cases and rulings is that even contingent interests do count for purposes of IRC § 267(c) but we do not know how to count them. *E.g.*, *Wyly v. United States*, 662 F.2d 397 (5th Cir. 1981); *Widener Trust No. 5 v. Commissioner*, 80 T.C. 304 (1983). To this extent, the cases and rulings are not helpful in figuring out how to apply IRC § 958(a)(2) to interests in discretionary trusts.

(c) In *Hickman v. Commissioner*, T.C. Memo. 72-208, 31 T.C.M. 1030 (1972), the Tax Court held that actuarial values cannot be used to apply the proportionate ownership rules for trust beneficiaries under IRC § 267(c)(1). So far, so good; this conclusion is consistent with the IRS's views expressed in FSA 199952014. In *Hickman*, the taxpayer challenged the IRS's method of computing proportionate ownership, but failed to convince the court that the IRS was incorrect. The taxpayers first suggested that actuarial values should be used to determine their proportionate interests in the trust's shares, but the court found no support for this approach in the legislation and its history. The

court also rejected the taxpayers' suggestion that the value of their interests in the shares owned by the trust was zero because they could not assign their interests in the trust. The court, however, did not describe how the IRS applied the proportionate ownership test other than referring to an IRS conclusion that the taxpayers owned more than 50% of the value of the shares because the taxpayers were the only present beneficiaries of the trust and because the trust had no specifically named remainder beneficiaries. Once again, the lack of discussion of how to apply the proportionate ownership test makes this decision useless to the indirect ownership rules.

(iv) Yet another possibility is the approach the IRS took in temporary regulations under IRC § 6038D.

(a) Under IRC § 6038D, a U.S. taxpayer must disclose the existence of and value of certain specified foreign financial assets to the IRS on Form 8938. An interest in a foreign trust is a reportable asset. Temp. Treas. Reg. § 1.6038D-3T(b)(iii).

(b) A taxpayer must know the value of his or her interest in a foreign discretionary trust in order to determine whether he or she meets the filing threshold, and if he or she does meet the filing threshold, what the value of his or her interest in such a trust is.

(c) The temporary regulations take a practical approach to the question of the value of an interest in a foreign discretionary trust by essentially providing that the maximum value of an interest in such a trust for a given year is the sum of the distributions from the trust to the beneficiary for that year. Temp. Treas. Reg. § 1.6038D-5T(f)(2)(i)(A). Therefore, if the beneficiary received no distributions from a discretionary trust, his or her beneficial interest in the trust has no value for purposes of the reporting requirements of IRC § 6038D. The temporary regulations take the appropriate position that if a beneficiary does not know about a discretionary trust or that he or she has an interest in the trust, he or she is not required to disclose the existence of that interest on Form 8938. Temp. Treas. Reg.

1.6038D-3T(c)(an interest in a foreign trust is not a reportable foreign financial asset unless the person "knows or has reason to know based on readily accessible information of the interest").

(d) The IRS took a realistic and sensible approach to the valuation of and accounting for interests in foreign discretionary trusts in the temporary regulations under IRC § 6038D, and this approach would be appropriate to apply in determining indirect ownership through a foreign trust under IRC § 958(a)(2). Unlike the maximum exercise of discretion standard, an approach based on actual distributions is much fairer and reflects the economics of the situation as well as, potentially, the beneficiary's lack of control over the trustee. Putting aside the question of control for the moment, such an approach to indirect ownership, which implicates both knowledge and actual benefit, is a fair way to approach the indirect ownership question.

E. *Constructive Ownership of CFC Shares by Beneficiaries of Foreign Trusts*

1. If the IRS cannot rely on the indirect ownership rules of IRC § 958(a)(2) to determine that the U.S. beneficiaries of a foreign trust indirectly own the trust's shares of a foreign corporation, the IRS may instead be able to determine that the beneficiaries constructively own some or all of the trust's shares under IRC § 958(b). These constructive ownership rules apply to determine whether a U.S. beneficiary is a 10% shareholder for purposes of determining whether a foreign corporation is a CFC. In this way, the constructive ownership rules are an alternate way to identify 10% shareholders and, therefore, to determine whether a corporation is a CFC.

2. It is important to understand, however, that if a person constructively owns shares in a CFC but does not own the shares directly or indirectly, that U.S. taxpayer will not be subject to tax on any part of the CFC's Subpart F income. The only purpose of the constructive ownership rules is to determine whether a corporation is a CFC – i.e. do 10% U.S. shareholders hold more than 50% of the shares of the CFC by vote or value? The only consequence to being a constructive owner, as opposed to being a direct or indirect owner, is reporting requirements.

3. Section 958(b) incorporates the constructive ownership rules of IRC § 318(a) to determine when a trust beneficiary will be deemed to constructively own shares of a corporation owned by a trust. Under IRC § 318(a)(2)(B)(i), stock owned by a trust will be considered to be owned by

its beneficiaries in proportion to the beneficiaries' actuarial interests in the trust.

4. The principal difference between the indirect ownership rules of IRC § 958(a)(2) and the constructive ownership rules of IRC § 958(b) is that the constructive ownership rules rely on actuarial values rather than "facts and circumstances" to determine a beneficiary's proportionate ownership of a trust's shares. Thus, a U.S. beneficiary can be deemed to constructively own a foreign trust's shares without regard to whether the beneficiary can vote the trust's shares or control the voting of the trust's shares.

5. The constructive ownership rules' reliance on actuarial values makes those rules simple to apply to foreign trusts with mandatory income interests and fixed remainder interests. *See, e.g.*, Treas. Reg. § 1.318-3(b). The regulations direct the use of actuarial factors and methods described in Treas. Reg. § 20.2031-7, which are estate tax valuation regulations, to compute the actuarial interests of trust beneficiaries. *Id.* Treasury Regulation § 20.2031-7 generally directs a taxpayer to use the IRC § 7520 actuarial factors to determine the value of annuities, life estates, and remainder interests. Treas. Reg. § 20.2031-7(d)(1)(for valuations after April 1, 1999). The tables provide an easy way to determine a beneficiary's pro rata ownership of trust-owned shares when the beneficiary has an interest capable of actuarial valuation.

6. The constructive ownership rules cannot, however, be applied when the beneficiaries' interests in the trust are discretionary, as is the case with most foreign trusts.

    a. The IRC § 958(b) constructive ownership rules rely on IRC § 318(a) to determine a beneficiary's proportionate ownership of trust owned stock. Section 318(a) in turn relies on IRC § 7520 and its actuarial factors to determine beneficiaries' proportionate interests in trusts. The regulations under IRC § 7520, however, do not permit the use of actuarial factors to determine the value of "restricted beneficial interests" in trusts:

    > A restricted beneficial interest is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest.

    Treas. Reg. § 20.7520-3(b)(1)(ii).

b. For example, if a trustee has discretion to divert or withhold income or principal distributions, actuarial factors cannot be used to compute the value of interests in the trust. *See* Treas. Reg. § 20.7520-3(b)(2)(ii)(B), (C).

c. When the IRC § 7520 factors are not applicable in determining the value of an interest in a trust, the taxpayer cannot rely on IRC § 7520 to value the interest. Rather, the taxpayer must determine the value of his or her trust interest based on "all of the facts and circumstances if and to the extent provided by the Internal Revenue Code provision applicable to the property interest." Treas. Reg. § 20.7520-3(b)(1)(iii).

d. The regulations under IRC § 318(a) provide that factors and methods described in Treas. Reg. § 20.2031-7 "shall be used" to compute actuarial values. Treas. Reg. § 1.318-3(b). That regulation and its related regulation, Treas. Reg. § 20.7520-3(b), however, effectively provide that the actuarial value of an interest in a discretionary trust cannot be computed. As a result, an interest in a discretionary trust should have no value for purposes of applying the constructive ownership rules of IRC § 958(b).

7. The IRS has confirmed the impossibility of determining the actuarial value of an interest in a discretionary trust.

a. An analysis of the Treasury Regulations under IRC § 367, for example, demonstrates that the IRS knows that valuing an interest in a discretionary trust under IRC § 318(a) is not possible.

(i) The regulations under IRC § 367 provide that stock owned by or for a trust shall be considered to be owned "proportionately by the persons who would be treated as owning such stock . . . under sections 318(a)(2)(A) and (B)." Treas. Reg. § 1.367(e)-1.

(ii) The regulations have an addition rule, however, for discretionary trusts:

> In applying section 318(a)(2)(B), if a trust includes interests that are not actuarially ascertainable, all such interests shall be considered to be owned by foreign persons.

Treas. Reg. § 1.367(e)-1(b)(2).

(iii) By coming up with a special rule to deal with interests that are not "actuarially ascertainable," the regulation tacitly acknowledges that IRC § 318(a)(2)(B) is of no use in

situations involving discretionary trusts. Interestingly, the preamble to the temporary regulations, which preceded the permanent regulations, provides that the IRS "is studying the determination of a beneficiary's actuarial interest in a trust, and may issue further guidance on this subject at a future date." T.D. 8472, 1993-1 C.B. 51, 52. The IRS did not address the issue when it issued the permanent regulations in 1999. *See* T.D. 8834, 1999-2 C.B. 251. Apparently the IRS is still studying this question.

b. The IRS demonstrated a similar view in regulations under the shipping income tax rules of IRC § 883 and the branch profits tax rules of IRC § 884.

(i) Both sections have rules that condition the availability of certain benefits to foreign corporations on the ownership by certain individuals of more than 50% of the value of the shares of the corporation. *See* IRC §§ 883(c)(1), 884(e)(4).

(ii) For purposes of both sections, shares owned by a trust are deemed to be owned proportionately by the trust beneficiaries. *See* IRC § 883(c)(4); Treas. Reg. § 1.884-5(b)(2)(iii).

(iii) Treasury Regulations under both sections address how to compute a beneficiary's proportionate ownership of a trust's shares. Treas. Reg. §§ 1.883-4(c)(3); 1.884-5(b)(2)(iii)(A). The regulations under IRC § 883, which came after the regulations under IRC § 884, use the same rules as the IRC § 884 regulations, so I will discuss only the IRC § 884 regulations. *See* 2000-8 I.R.B. 654, 662.

(iv) The Treasury Regulations under IRC § 884 generally provide for the determination of a beneficiary's constructive ownership of a trust's shares by reference to IRC § 318(a)(2). Treas. Reg. § 1.884-5(b)(2)(iii)(A).

(v) In the regulations, however, the IRS appears to have recognized that the actuarial approach in IRC § 318(a)(2) would not work when the trust was a discretionary trust:

> In general, a person shall be treated as having an interest in stock of a foreign corporation owned by a trust or estate in proportion to the person's actuarial interest in the trust or estate, as provided in section 318(a)(2)(B)(i), except that an income beneficiary's actuarial interest in the

> trust will be determined as if the trust's only asset were the stock. The interest of a remainder beneficiary in stock will be equal to 100 percent minus the sum of the percentages of any interest in the stock held by income beneficiaries. The ownership of an interest in stock owned by a trust shall not be attributed to any beneficiary whose interest cannot be determined under the preceding sentence, and any such interest, to the extent not attributed by reason of this paragraph (b)(2)(iii)(A), shall not be considered owned by a beneficiary unless all potential beneficiaries with respect to the stock are qualifying shareholders.

Id.

(vi) Stated another way, the IRS views a beneficial interest that cannot be determined by reference to actuarial tables to have no value. The IRS's use of this approach is understandable given that the IRS was attempting to limit a benefit under the branch profits tax rule to situations in which certain taxpayers were sure to receive benefits from the trust. To this extent, the regulation reflects the realistic view that you cannot determine the actuarial value of a beneficiary's interest in a discretionary trust. Taking this approach, of course, was to the government's benefit under IRC § 884 because it made it harder for a corporation to qualify for benefits.

(vii) The IRS should take a similar approach in attempting to determine the actuarial value of an individual's interest in a discretionary trust under IRC § 958(b). The IRS should be consistent in applying IRC § 958(b) even though the approach disfavors the government.

c. Commentators sometimes refer to cases and rulings under the personal holding company rules as providing a method for determining the actuarial value of beneficial interests in discretionary trusts.

(i) IRC § 544(a)(1) provides that for purposes of determining whether a corporation is a personal holding company, shares owned by an estate or trust are considered to be owned proportionately by the estate or trust beneficiaries.

(ii) The IRS has not issued any regulations under IRC § 544(a)(1) that describe how to apply the proportionate ownership test. As a result, courts and the IRS have had to develop the rules for applying the proportionality test in decisions and rulings. Those decisions and rulings have generally based proportionate ownership on actuarial values, though without reference to any particular way of computing actuarial values. This ad hoc approach has left the IRS to struggle with how to determine the actuarial value of an interest in a discretionary trust for purposes of IRC § 544(a)(i).

(iii) In PLR 9024076 the IRS attempted to come up with an actuarial value of an interest in a discretionary trust for IRC § 544(a)(1) purposes. In that ruling the IRS considered these facts and circumstances:

(a) Patterns of past distributions;

(b) Appropriate mortality assumptions;

(c) The trustee's fiduciary duties; and

(d) The relationships among the trustees and beneficiaries.

(iv) A close reading of PLR 9024076 shows that the IRS was not really computing actuarial values of beneficial interests in the trust within the common meaning of that term. Rather, the IRS was using qualitative factors to determine the value of a beneficiary's interest in a discretionary trust.

(v) The IRS appears to have recognized the disingenuousness of the multifactor approach to determining actuarial values of interests in discretionary trusts in a 1994 Field Service Advisory Memorandum.

(a) In FSA 1644 (July 14, 1994), the IRS National Office considered how the proportionate ownership rules of IRC § 544(a)(1) should apply to a discretionary trust held for the benefit of a single beneficiary for purposes of applying certain of the passive loss rules. The trustee of the trust had discretion to make or not make distributions of income to the beneficiary, and the beneficiary was not entitled to receive principal distributions.

(b) Although the IRS could have used the multi-factor approach of PLR 9024076 to deem the beneficiary to own the trust's stock, the National Office instead took the view that court decisions and Revenue Ruling 62-155 required the use of a strict actuarial approach in applying the indirect ownership rules of IRC § 544(a)(1).

(c) The National Office advised the field that that "because of the discretionary nature of [the trust], particularly the trustee's power to completely withhold income and the uncertainty of the identity of the remaindermen, [the beneficiary] has no *actuarially determinable interest* in the trust. Accordingly, the National Office advised that the beneficiary could not be deemed to own the trust's stock in the corporation under IRC § 544(a)(1). This result contradicts the result in PLR 9024076.

d. The IRS might suggest that it could determine the actuarial value of an interest in a discretionary trust by considering the maximum extent of the trustee's discretion to make a distribution to that beneficiary. The IRC § 7520 regulations, however, preclude the government from making such an argument.

(i) For example, under IRC § 1563(e)(3)(A):

> stock owned, directly or indirectly, by or for a . . . trust shall be considered as owned by any beneficiary who has an *actuarial* interest of 5 percent or more in such stock, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the *maximum exercise of discretion* by the fiduciary in favor of such beneficiary and the maximum use of such stock to satisfy his rights as a beneficiary." §1563(e)(3)(A)(emphasis added).

(ii) The treasury regulations under IRC § 1563 provide further that "a beneficiary of a . . . trust who cannot under any circumstances receive any interest in stock held by the . . . trust, including the proceeds from the disposition thereof, or the income therefrom, does not have an actuarial interest in such stock. However, an income beneficiary of a trust

does have an actuarial interest in stock if he has any right to the income from such stock even though under the terms of the trust instrument such stock can never be distributed to him." Treas. Reg. §1.1563-3(b)(3)(i). Thus, to the extent the trust provides expressly that a beneficiary may have no interest in either the income or the disposition proceeds of stock owned by a trust, ownership of the stock will not be attributed to the beneficiary.

(iii) The "maximum exercise of discretion" rules in the consolidated return regulations are not relevant to the determination of actuarial values under IRC § 7520. As noted above, those regulations provide that the value of a restricted beneficial interest cannot be determined by reference to the actuarial tables. The IRC § 7520 regulations do not have a "maximum exercise of discretion" assumption in them; the IRS would have to revise the regulations to bring such a standard into the regulations. Thus, the plain language of the IRC § 7520 regulations cut off the ability of the government to make a "maximum exercise of discretion" argument in applying the constructive ownership rules of IRC § 958(b).

F. *Compliance Issues for Shareholders of CFCs*

1. A U.S. taxpayer who owns more than 10% of the total combined voting power of a CFC must file a Form 5471 if he or she owned that 10% or more of the shares for an uninterrupted period of more than 30 days during the tax year of the CFC or owned that 10% or more of the shares on the last day of the CFC's tax year. *See* IRC § 6038(a)(4)(giving the IRS authority to require a 10% shareholder to file an informational return).

2. The IRS used the authority given to it by Congress to require a 10% shareholder to file a Form 5471 simply by instructing a shareholder to do so on Form 5471. The IRS did not promulgate regulations requiring such a filing. A 10% shareholder of a CFC is a Category 5 filer.

3. A U.S. taxpayer is required to file a Form 5471 as a Category 5 filer if he or she directly, indirectly, or constructively owns 10% or more of the total combined voting power of all classes of stock of a CFC entitled to vote. *See* IRC § 951(b)(defining a "U.S." shareholder for purposes of Subpart F). If, however, the U.S. person does not directly or indirectly own any shares of the CFC, but only constructively owns shares through a nonresident alien, that U.S. person is not required to file a Form 5471.

4. Just because a U.S. taxpayer must file a Form 5471 does not mean that he or she will be taxable on a share of the CFC's Subpart F income. If the

U.S. person does not own any shares directly or indirectly, but only constructively, he or she will not be liable for a pro rata share of the CFC's Subpart F income. *See* Instructions to IRS Form 5471 at 3. *See also* Treas. Reg. § 1.6038-2(l)(similar rule for a Category 4 filer). *See generally* IRC § 951.

XI. Passive Foreign Investment Company Shares Owned by Trusts and Estates

A. *What is a PFIC?*

1. A PFIC is a foreign corporation that meets one of these tests:

   a. 75% or more of the gross income of the corporation is "passive" income. IRC § 1297(a)(1).

   b. The average percentage of assets held by the corporation during a taxable year that produce passive income or are held for the production of passive income is at least 50%. IRC § 1297(a)(2).

2. Subject to certain limited exceptions, "passive income" is foreign personal holding company income within the meaning of IRC § 954(c). *See generally* IRC § 1297(b).

3. In determining whether a foreign corporation is a PFIC, if a foreign corporation owns at least 25% of the stock of another corporation, then the first corporation will be deemed to own a pro-rata share of the assets of the other corporation and directly received a pro-rata share of the other corporation's income. IRC § 1297(c). This rule effectively permits the use of holding company to own a foreign operating business without that holding company being classified as a PFIC.

4. The PFIC regime does not apply to a U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation. IRC § 1297(e). *See also* PLR 200943004. Because such a shareholder is currently taxable on her share of the CFC's Subpart F income, it is unnecessary to subject him or her to the PFIC tax regime; the CFC rules accomplish Congress's anti-deferral objectives.

B. *Taxation of Distributions From a PFIC*

1. A special tax regime applies when a U.S. shareholder receives a distribution from a PFIC. Unlike the normal rules of U.S. federal corporate income taxation, a PFIC's earnings and profits are often not relevant to the taxation of a PFIC distribution. Rather, the taxation of a PFIC distribution depends on the relative size of the distribution as compared to the PFIC's distributions in prior years, including the years before the corporation became a PFIC.

2. Distributions from a PFIC fall into two categories, "excess" and "nonexcess" distributions. An excess distribution is the portion of a distribution from a PFIC that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the three preceding years included in the shareholder's holding period or, if the shareholder's holding period is less than three years, the holding period. IRC § 1291(b)(2)(A). A nonexcess distribution is the part of a distribution that is not an excess distribution.

3. The portion of a PFIC distribution that is a nonexcess distribution is taxed to the shareholder based on the general rules of U.S. corporate income taxation, which will usually result in dividend treatment. Prop. Treas. Reg. § 1.1291-2(e)(1). The nonexcess distribution from a PFIC will not qualify for the 15% rate on qualified foreign dividends because a PFIC by definition is not a "qualified foreign corporation." IRC § 1(h)(11)(C)(iii).

4. The portion of a PFIC distribution that is an excess distribution is subject to a special tax regime. The taxpayer must first allocate the distribution pro rata to each day in the shareholder's holding period for the shares. IRC § 1291(a)(1)(A). Whether the PFIC had earnings and profits in those years is irrelevant. The portion of the excess distribution allocated to the current year and the pre-PFIC years is included in the taxpayer's income for the year of receipt as ordinary income. IRC § 1291(a)(1)(B)(i), (ii). Those amounts of the excess distribution are not qualified dividends for federal income tax purposes. *See* IRC § 1(h)(11)(C)(iii) (a foreign corporation that is a PFIC is not a "qualified foreign corporation").

5. The portion of the excess distribution allocated to other years in the taxpayer's holding period (the "PFIC years") is not included in the shareholder's income. Rather, this portion is subject to a special "deferred tax" that the taxpayer must add to her tax that is otherwise due. *See* IRC § 1291(c). To compute the deferred tax the shareholder must first multiply the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year. IRC § 1291(c)(1). The shareholder then aggregates all the "unpaid" tax amounts for the PFIC years. IRC § 1291(c)(2). The shareholder must then compute interest on those increased tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal underpayment rate. IRC § 1291(c)(3). The taxpayer includes the deferred tax and interest as separate line items on his or her individual income tax return. *See* IRC § 1291(a)(1)(C). The effect of the deferred tax and the interest charge is similar to the throwback rule that applies to accumulation distributions from foreign trusts.

6. Tax law treats the sale of PFIC shares as an excess distribution to the extent the proceeds of sale exceed the seller's basis in the PFIC shares. IRC § 1291(a)(2). The effect of these rules is to treat the gain as ordinary

income realized ratably over the seller's holding period with deferred tax and interest on the amounts allocated to prior years.

C. *Alternate Tax Regimes*

1. Instead of subjecting himself or herself to the excess distribution regime, a U.S. shareholder of a PFIC may make a "qualified electing fund" or "QEF" election for his or her shares. If the shareholder makes this election, he or she must include in his or her gross income a pro rata share of the PFIC's ordinary income and net capital gain for a taxable year. *See generally* IRC § 1293(a). Thus, instead of waiting until the PFIC makes a distribution, the shareholder elects to be taxed currently on the PFIC's earnings and profits. If a shareholder makes this election, however, he or she must have access to the PFIC's books and records so that he or she can determine how to compute their allocable share of the PFIC's income and gains.

2. If a U.S. taxpayer acquires shares in a PFIC which are "marketable," the shareholder may make a "mark to market" election for the shares. *See generally* IRC 1296. A PFIC's shares are marketable when the shares are regularly traded (as defined in Treas. Reg. § 1.1296-2(b)) on:

   a. A national securities exchange that is registered with the Securities and Exchange Commission (SEC);

   b. The national market system established under section 11A of the Securities and Exchange Act of 1934; or

   c. A foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and has the characteristics described in Regulations section 1.1296-2(c)(1)(ii).

   Instructions to IRS Form 8621 (Rev. December 2013) at 2. Under the mark to market regime, the shareholder includes the excess of fair market value of the PFIC shares over his or her adjusted basis in the shares in gross income on an annual basis. The shareholder may adjust his or her basis in the shares for the amount of income subject to inclusion under the mark to market regime.

D. *Estate Planning Issues for Individuals Who Own PFIC Shares*

1. Death as a Disposition?

   a. The death of an owner of PFIC shares may result in a deemed disposition of his or her PFIC shares. By way of background, the Internal Revenue Code usually treats transfers of assets by reason of death as a nonrecognition event for income tax purposes. Under

the PFIC rules, however, any transfer by a U.S. owner of PFIC shares that would normally be a nonrecognition transaction is generally deemed to be a taxable disposition of the PFIC shares. IRC § 1291(f).

b. The transfer of assets at death is not a recognition event for federal income tax purposes. Thus, the death of a U.S. owner of PFIC shares appears to be a taxable disposition of those shares under IRC § 1291(f). If, however, the effect of the death of a U.S. taxpayer who owns PFIC shares is a transfer of the shares to a domestic estate or directly to another U.S. taxpayer, then the shareholder's death is not a taxable event. Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A). The transfer of PFIC shares by a U.S. taxpayer on death to a testamentary trust or to a foreign person, however, is a taxable disposition. *See* Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(B). The proposed PFIC regulations treat a death-related disposition as a transfer by the shareholder immediately before his or her death, making the transfer taxable to the shareholder during his or her last taxable year. Prop. Treas. Reg. § 1.1291-6(d)(2).

c. If a U.S. taxpayer owns shares of a PFIC through a grantor trust, the taxpayer's death would be a taxable disposition of the shares unless one of the exceptions applies. *See* Prop. Treas. Reg. § 1.1291-6(c)(3)(iv). These rules apply to a trust that is a grantor trust by reason of the settlor's retained powers as well as a trust that is a grantor trust by reason of IRC § 678. If a U.S. beneficiary holds a testamentary general power of appointment, however, the trust will not be a grantor trust and, therefore, the grantor trust disposition rules will not apply.

2. Basis Issues

a. IRC § 1014 generally provides that a taxpayer who receives property from a decedent will receive a new basis in the property equal to the value of the property on the decedent's date of this death.

b. The step-up in basis nominally applies to PFIC shares. Under IRC § 1291(e)(1), however, a shareholder's basis in PFIC shares received from a decedent is reduced by the difference between the new basis awarded under IRC § 1014 and the decedent's adjusted basis in the PFIC shares immediately before the decedent's death. Thus, there is effectively no new basis in PFIC shares received from a decedent. The statute is not a model of clarity because it refers to rules similar in effect to rules that were part of IRC § 1246 before its repeal by the American Jobs Creation Act of 2004.

c. The basis reduction rule does not apply to PFIC shares received by a U.S. shareholder by reason of the death of a nonresident alien decedent if the decedent was a nonresident alien during her entire holding period. IRC § 1291(e)(2).

E. *Issues for Domestic Trusts that Own PFIC Shares*

1. Introduction

a. The income tax rules related to PFICs are fairly easy to apply individual U.S. taxpayers. The rules, however, are much more difficult to apply to domestic trusts that own PFIC shares and the trust's beneficiaries because the concepts used by Congress in the PFIC rules conflict with many of the principles of Subchapter J.

b. In the proposed PFIC regulations the IRS acknowledged that application of the PFIC rules to trusts and their beneficiaries presented complicated issues. The IRS, however, did not give any guidance on how to apply to these rules to a trust that owns shares in a PFIC and its beneficiaries. In sections of the proposed regulations where the IRS had in mind to address trusts and their beneficiaries, the IRS simply wrote "reserved." Prop. Treas. Reg. §§ 1.1291-2(f)(2)(i), 1.1291-2(f)(2)(ii)(B), 1.1291-3(e)(5)(ii).

c. In light of the lack of any rules on the subject, the preamble to the proposed regulations simply directs the "shareholder" – which could be the trust or the beneficiary – to apply the PFIC rules and Subchapter J in a reasonable manner that triggers or preserves the interest charge.

2. Effect of a PFIC Distribution to a Domestic Trust

a. If a domestic trust receives a distribution from a PFIC, the nonexcess portion of the distribution will be included in the trust's DNI to the extent that the nonexcess portion constitutes taxable income. *See* IRC § 643(a); Prop. Treas. Reg. § 1.1291-2(e)(1).

b. The trust's DNI will also include the excess portion of the distribution attributable to the current year and to pre-PFIC years. *See* IRC § 643(a); IRC § 1291(a)(1)(B). If, however, the trust is a simple trust or a complex trust with Tier 2 beneficiaries, applying the PFIC rules in a manner consistent with the principles of Subchapter J is very difficult because the two regimes are so different.

c. It might seem like the PFIC rules would be easy to apply to a simple trust because unlike the CFC rules, the PFIC rules focus on the receipt of a distribution from a corporation rather than on

imputing income. Nevertheless, applying the PFIC rules to a simple trust raises a number of issues.

(i) Under general tax principles, the current year portion of the excess distribution will be included in the trust's DNI. The trust will receive a deduction for the amount of the DNI and the beneficiary will include the DNI in his or her income. *See* IRC §§ 651, 652.

(ii) The excess distribution allocated to prior tax years, however, is not included in DNI, so the trust would not receive a deduction for that amount. *See* IRC § 651(b) (distribution deduction limited to DNI, and DNI does not include items of accounting income not included in taxable income). That part of the excess distribution, however, would be includable in the trust's accounting income, which would require the trustee to distribute that amount to the beneficiary. Doing so, however, could leave the trustee with the deferred tax and interest obligation on the amount of the excess distribution allocated to prior years without any cash to pay the tax and interest.

(iii) The trustee could treat the deferred tax and interest as income related expenses for accounting purposes and reduce the accounting income accordingly. This should work all right as long as the deferred tax and interest do not exceed the gross amount of the excess distribution allocated to prior years. Alternatively, the trustee could make an adjustment to income by not allocating the excess distribution amount to income if state law permits such an adjustment. Such an approach should be appropriate under the PFIC rules because it preserves the deferred tax and the interest charge.

d. Applying the distribution tax rules to a domestic complex trust is easier.

(i) The trustee of a complex trust will include the current year portion of an excess distribution in the trust's DNI. If the trustee makes a distribution, the distribution will carry out some or all of the current year excess portion and the tax associated with it. *See* IRC §661(a).

(ii) The trustee presumably would not distribute the excess portion allocated to prior years but rather retain that portion as a source of funds to pay the deferred tax and interest. This is a reasonable way to approach the PFIC rules in

connection with trusts and preserves the deferred tax and interest charge.

3. Sales of PFIC Shares by a Domestic Trust

a. Tax law treats the sale of PFIC shares as an excess distribution to the extent the proceeds of sale exceed the seller's basis in the shares. IRC § 1291(a)(2). The effect of these rules is to treat the gain as ordinary income realized ratably over the seller's holding period with deferred tax and interest on the amounts allocated to prior years.

b. The tax effects of a sale of PFIC shares by a domestic trust are fairly straightforward. If a domestic trust sells PFIC shares, the proceeds of sale will be capital gain and, therefore principal, for fiduciary accounting purposes. Although the PFIC rules treat the gain as an excess distribution, turning the current portion of the gain into ordinary income, the gain should not be includable in the trust's DNI. *See* IRC § 643(e)(3) (a domestic trust's DNI does not ordinary include the trust's capital gains).

c. Although the PFIC rules treat the "gain" as ordinary income, the treatment of the gain as an excess distribution under the PFIC rules should not change the character of the gain for fiduciary income tax purposes. *See* IRC § 1291(a)(2)(when a taxpayer disposes of stock in a PFIC, the excess distribution rules will apply to any "gain" recognized as if the "gain" was an excess distribution); Prop. Treas. Reg. § 1.1291-3(a)(referring to a "gain" from the sale of PFIC shares being taxed as an excess distribution); Prop. Treas. Reg. § 1.1291-3(c)(a direct shareholder of an interest in a PFIC "recognizes all gain that it realizes on the disposition" of the interest). Because the gain will not be includable in DNI, the trustee will pay the tax on the gain (as recharacterized). The trustee will also pay the deferred tax and interest.

4. Distributing PFIC Shares From a Domestic Trust

a. The distribution of PFIC shares from a domestic trust may result in a taxable disposition of the shares.

b. The distribution of property from a trust usually is a nonrecognition event for federal income tax purposes unless the trustee elects to treat the disposition as a taxable transaction under IRC § 643(e). The general nonrecognition rules of the Code, however, do not apply to dispositions of PFIC shares. IRC § 1291(d). Thus, a distribution of PFIC shares from a domestic trust

or estate will be treated as taxable disposition of the shares. Prop. Treas. Reg. § 1.1291-6(a)(2).

c. The proposed regulations, however, effectively provide that a distribution from a domestic trust or estate to a U.S. taxpayer beneficiary is not taxable as long as the trustee does not make an IRC § 643(e) election. *See* Prop. Treas. Reg. § 1.1291-6(c)(2). Thus, taxation is likely to be a risk only when a domestic trust makes a distribution to a non-U.S. beneficiary. Such a beneficiary will receive a basis adjustment to reflect the taxation of the distribution, although the basis will not be relevant to that beneficiary. *See* Prop. Treas. Reg. § 1.1291-6(b)(4).

d. If a trust makes a distribution to a charitable organization that qualifies for an IRC § 642(c) deduction, the trust may reduce an excess distribution. *See generally* Prop. Treas. Reg. § 1.1291-2(d)(5)(implementing regulatory authority granted by IRC § 1291(b)(3)(G)). In general, the trust can reduce the excess distribution by some or all of the charitable deduction amount, depending on how much other property the trust has besides the PFIC shares.

F. *Subchapter J Issues When a Foreign Trust Owns PFIC Shares*

1. Taxation of Distributions in the Hands of U.S. Beneficiaries

a. If a foreign complex trust receives an excess distribution from what would be a PFIC under U.S. rules, that distribution will have excess and nonexcess portions. The nonexcess portion will be included in the trust's DNI for that year. *See* IRC § 643(a)(6)(A). The portion of the excess distribution allocated to the current year and pre-PFIC years will also be allocated to DNI. *Id.*

b. If the trust makes a distribution to a U.S. beneficiary in the year of receipt of the PFIC distribution, that beneficiary will pick up some or all of the PFIC distribution included in DNI in his or her income in accordance with the character rule. *See* IRC § 662(b). If the trust does not make any distributions during the year, the portions of the distribution included in DNI will become UNI. *See* IRC § 665(a). In this way, a later distribution of the income would be subject to a penalty tax and interest through the throwback rule rather than through the PFIC rules.

c. The treatment of the portion of the excess distribution to a foreign complex trust that is allocated to prior years under the PFIC rule is unclear. Because the portion of the excess distribution allocated to prior years is not included in the trust's notional U.S. taxable

income, the excess portion is not included in the trust's DNI. *See* IRC § 643(a)(1). The allocation of the excess portion to prior years cannot convert that income to UNI for those prior years because the excess portion is not DNI. *See* IRC § 665(a)(defining UNI by reference to DNI).

d. This issue will arise when a foreign complex trust makes a distribution to a U.S. beneficiary that exceeds the amount of the PFIC distribution that was included in DNI. The distribution from the PFIC to the foreign trust should be fiduciary accounting income. The distribution of that accounting income to the beneficiary will not in and of itself be an accumulation distribution that draws out UNI from the trust. *See* IRC § 665(b). Thus, even if the IRS took the position that the excess distribution allocated to prior years was UNI, the distribution of accounting income to a U.S. beneficiary would not pull out that UNI.

e. Taking such a position, however, would effectively defeat the purposes of the deferred tax and the interest charge. In fact, taking this position would allow the avoidance of U.S. income tax on the noncurrent portion of an excess distribution. In this situation, the foreign trust could distribute the full amount of the excess distribution to a U.S. beneficiary but the U.S. beneficiary would pay tax only on the current portion of the excess distribution. The U.S. beneficiary would receive the balance of the excess distribution without any tax consequences because that portion of the distribution did not constitute current DNI of the trust and because the distribution would not attract UNI. If the trust retained the excess distribution, the noncurrent portion of the excess distribution would not be UNI because the noncurrent portion was not DNI.

f. These results reflect the Congressional tax writers' and the PFIC regulation writers' lack of understanding of the Subchapter J rules. Based on the way Congress constructed the PFIC rules, however, it is unclear how those rules can be reconciled without legislation. The IRS could perhaps issue regulations under IRC § 643(a)(7) to define a foreign trust's DNI to include any distribution from a PFIC in the year of receipt. Doing so, however, would forgo the deferred income tax and interest on the excess part of the PFIC distribution. In order to capture the deferred income tax from a trust beneficiary who receives a distribution that includes an excess distribution, Congress would have to change the fiduciary income tax rules.

g. Although the government might not be able to collect the deferred income tax and interest under the direct ownership rules, it may be

able to do so under the indirect ownership rules of IRC § 1298(a)(3). As discussed below, those rules may allow the IRS to treat the beneficiary as having indirectly received a portion of the excess distribution allocated to prior years of the foreign trust.

2. Effect of Sale of PFIC Shares by a Foreign Trust

a. The effect of a complex foreign trust's sale of PFIC shares is also difficult to square with Subchapter J. Because a foreign trust is not a U.S. taxpayer, its sales of PFIC shares do not have an immediate tax consequence. U.S. tax consequences, however, arise if the foreign trust makes a distribution to a U.S. beneficiary.

b. Under IRC § 643(a)(6) a foreign trust's DNI includes "amounts of gross income" from non-U.S. sources. In addition, a foreign trust's DNI includes realized capital gains. If a foreign trust sold PFIC shares, U.S. tax law would treat the gain from the sale as an excess distribution. IRC § 1291(a)(2). Thus, to compute its notional U.S. income, the trust would have to allocate the gain across its holding period on a daily basis. *See* IRC § 1291(a)(1)(A). Under IRC § 1291(a)(1)(B), a foreign trust's gross income for the year of the disposition would include only the current amount of the excess distribution and the pre-PFIC portion of the excess distribution. The balance of the gain would not be includable in gross income and, therefore, not includable in the foreign trust's DNI. For the reasons discussed above with respect to PFIC distributions, the "untaxed" portion of the gain could avoid U.S. income taxation whether the trust distributes the gain or retains the gain.

c. The application of the PFIC rules and Subchapter J rules in this manner would have the effect of avoiding the deferred tax and the interest charge on the gain from the sale of PFIC shares. The proposed regulations, however, under IRC § 1291 do not address the application of the deemed disposition rules to trusts, estates, and their beneficiaries. *See* Prop. Treas. Reg. § 1.1291-3(e)(5)(ii)(proposed regulations on the application of the indirect disposition rules to trusts, estates, and their beneficiaries are "[Reserved]"). Without any authority we are simply left to guess at how to apply the Code rules in a reasonable manner consistent with Subchapter J in a way that preserves the deferred tax and the interest charge.

3. Effect of Distribution of PFIC Shares From a Foreign Trust

a. The distribution of PFIC shares from a foreign trust to a U.S. beneficiary will not trigger a gain because the trust will not be subject to U.S. income tax. The beneficiary, however, will not

receive a new basis in the PFIC shares, even if the foreign trust makes an IRC § 643(e) election. Prop. Treas. Reg. § 1.1291-6(d)(3). *See generally* IRC § 643(e)(trust beneficiary does not receive a new basis in trust property distributed in kind from a trust or estate).

b. If the foreign trust satisfies a pecuniary distribution or bequest with appreciated PFIC shares, the U.S. beneficiary should receive a new basis in the shares because the distribution from the trust would have been a taxable disposition if the trust was not foreign. In this situation, however, the IRS might treat the beneficiary as the indirect owner of the PFIC shares distributed to her and tax her on the deemed gain.

4. Effect of Domestication of a Foreign Trust That Owns PFIC Shares

a. If a foreign trust becomes a domestic trust and the domestication does not otherwise result in a deemed disposition of the trust's PFIC shares, the domestication should not trigger any PFIC-related taxes to the trust. Furthermore, the Proposed Treasury Regulations in effect provide that the excess distribution regime will apply only for those days in a shareholders' holding period in which the shareholder was a United States person. Prop. Treas. Reg. § 1.291-1(b)(i).

b. Thus, while a domesticated trust's holding period for excess distribution purposes will include its entire holding period, including the pre-immigration period, the deferred tax and interest will be computed based only on those days in the holding period in which the trust was a domestic trust. The way the rules work, however, all the gains from the disposition of the PFIC shares will be taxed as ordinary income and not as capital gains.

G. *Indirect Ownership of PFIC Shares Through Estates and Trusts*

1. Introduction

a. The PFIC tax regime applies to U.S. taxpayers who directly or indirectly own shares of a PFIC. The direct and indirect ownership rules work together to "find" the first U.S. taxpayer in the ownership chain and subject him or her to the PFIC tax regime on excess distributions. *See* IRC § 1298(a). If a U.S. citizen or resident directly owns shares in a PFIC, he or she will be directly subject to the PFIC tax regime.

b. Indirect ownership rules apply when an estate or trust owns PFIC shares. *See* IRC § 1298(a)(3) (shares in a PFIC owned by an estate or trust will be considered as owned "proportionately" by its

beneficiaries). In 1992 the IRS issued proposed regulations under what was then IRC § 1297(a)(3). Those regulations, which are still in proposed form, generally provide that a trust beneficiary will be deemed to own a proportionate amount of the stock owned by the trust. Prop. Treas. Reg. § 1.1291-1(b)(8)(iii)(C). The proposed regulations provide that indirect ownership depends on the facts and circumstances in each case, with the substance rather than the form of ownership controlling, taking the purposes of the PFIC rules into account. Prop. Treas. Reg. § 1.1291-1(b)(8)(i). Unlike the CFC rules, the PFIC rules do not rely on the constructive ownership principles of IRC § 318(a) to attribute ownership of PFIC shares of stock from one person to another.

c. The proposed regulations did not address how to apply the proportionate ownership rule to trusts and estates and their beneficiaries. In the preamble to the proposed regulations the IRS solicited comments as to "whether different attribution rules, such as the indirect ownership rules in section 25.2701-6 (relating to special valuation rules for purposes of estate and gift taxes), should be adopted for purposes of determining whether a beneficiary of a trust or estate is an indirect shareholder of a PFIC." 1992-1 C.B. 1124, 1125. At least one law firm submitted comments on the attribution rules in the proposed regulations. The IRS, however, has not taken any action to finalize these now 12-year old proposed regulations. Furthermore, the IRS has not issued any public or private rulings on this subject. The outline discusses the possible application of "maximum exercise of discretion" indirect ownership rule of Treas. Reg. § 25.2701-6 above at pages 15-17, concluding that the approach would not be appropriate to determine indirect ownership of shares through a trust for CFC purposes. Apply the maximum exercise of discretion approach for PFIC purposes would be inappropriate for the same reason it is inappropriate for CFC purposes: the approach does not focus on who actually receives the benefit of deferring U.S. income tax through investing in a foreign corporation.

d. As discussed in detail below, however, in 2007 the IRS National Office took on this issue in a technical advice memorandum, relying on the CFC rules.

2. Indirect Ownership Through Domestic Trusts and Estates

a. IRC § 1298(a)(1) generally provides that once you find a U.S. shareholder of PFIC shares under the direct or indirect PFIC share ownership rules, no other person will be deemed to own the shares for U.S. income tax purposes. The Secretary of the Treasury, however, can provide in regulations that PFIC shares owned by a

U.S. person may be deemed to be owned by another person. IRC § 1298(a)(1)(B).

b. The IRS could use this authority to deem beneficiaries of domestic trusts and estates to indirectly own PFIC shares owned by a trust or estate. In fact, the proposed PFIC regulations have a general rule that PFIC shares owned by an estate or trust will be deemed to be owned proportionately by the beneficiaries of the estate or trust. Prop. Treas. Reg. § 1.1291-1(b)(8)(iii)(C). These proposed regulations do not differentiate between foreign estates and trust and domestic estates or trusts. You might think, therefore, that the IRS is attempting to generally apply the indirect ownership rules to domestic trusts and estates that own PFIC interests. As discussed below, the indirect ownership rules may provide a tempting way to overcome the difficulties associated with the coordination of the excess distribution rules and Subchapter J.

c. The proposed regulations, however, are just that: proposed. They are not final regulations or even temporary regulations. Absent final or temporary regulations, the general rule of IRC § 1298(a)(2) should control: Once you find a U.S. owner of PFIC shares, the inquiry stops. IRC § 1298(a)(1).

3. Indirect Ownership Through Foreign Estates.

a. There are no proposed regulations under IRC § 1298(a)(3) with respect to foreign estates with U.S. beneficiaries. The CFC indirect ownership rules are probably the closest in spirit to the PFIC rules because both sets of rules seek to discourage and punish U.S. investors' deferral of U.S. income tax by investing in foreign corporations. In fact, the IRS referred to the CFC rules in the proposed PFIC regulations in connection with the facts and circumstances test of indirect ownership. Prop. Treas. Reg. § 1.1291-1(b)(8)(i) ("In applying this paragraph (b)(8), the determination of a person's indirect ownership is made on the basis of all the facts and circumstances in each case; the substance rather than the form of ownership is controlling, taking into account the purpose of section 1291. *Cf. section 1.958-1(c)(2)*") (emphasis added). For this reason, the facts and circumstances on which the government relies to apply the CFC indirect ownership rules under IRC § 958(a)(2) are the most useful ones to look to in predicting how the IRS would interpret IRC § 1298(a)(3).

b. The application of the CFC indirect ownership rules to estates is discussed above. You could take the approach used in the CFC indirect ownership rules with respect to the indirect ownership of PFIC shares of a foreign estate.

4. Indirect Ownership of PFIC Shares Through Foreign Trusts

   a. Because there are no proposed regulations under the PFIC indirect ownership rules with respect to trusts and their beneficiaries, again the logical place to look for inspiration is the CFC indirect ownership rules for trusts and their beneficiaries.

   b. The CFC trust-beneficiary indirect ownership rules are fairly easy to apply to trusts with mandatory income interests. *See* Treas. Reg. § 1.958-(d), Example (3).

   c. As discussed above, however, the CFC rules have no clear guidelines on when a U.S. beneficiary of a foreign discretionary trust will be deemed to own a proportionate share of such a trust's shares in a foreign corporation.

5. TAM 200733024

   a. In a 2007 National Office Technical Advice Memorandum, TAM 200733024, the IRS used a "facts and circumstances" test in applying IRC § 1298(a)(3) to trusts and their beneficiaries:

   > Section 1298(a)(3) states that "[s]tock owned, directly or indirectly, by or for a partnership, estate or trust shall be considered as being owned proportionately by its partners or beneficiaries. No temporary or final regulations have been promulgated under section 1298(a)(3). However, unlike section 1298(b)(5), section 1298(a)(3) contains no language contemplating the promulgation of regulations and there is therefore no ambiguity with regard to its applicability.
   >
   > *   *   *
   >
   > Regulations have been issued under subpart F, another anti-deferral regime, that provide a method of allocating subpart F income to the beneficiaries of a trust that holds an interest in a controlled foreign corporation.
   >
   > *   *   *
   >
   > In the absence of temporary or final regulations under section 1298(a)(3), the Service proposes to determine the beneficiaries' proportionate share of the stock of Corp J by applying a facts and circumstances analysis, following the method imposed under the subpart F regulations.

b. The TAM involved the application of the indirect ownership rules to a foreign discretionary trust that liquidated a PFIC. The IRS's reliance on the CFC indirect ownership rules is not surprising, given that the PFIC rules and the CFC rules have a similar purpose: to discourage U.S. taxpayers from deferring U.S. income tax on passive investments by using foreign corporations to hold those investments. The IRS's application of the CFC indirect rules to the facts presented in TAM 200733024, however, raises a number of questions, particularly in the context of dispositions of PFIC interests by foreign trusts.

c. To the extent the IRS applies the CFC facts and circumstances approach suggested in TAM 200733024 when a foreign trust receives a PFIC dividend that was an excess distribution, the IRS should focus on the trust's distributions in the year in which the trust receives the dividend and treat those beneficiaries as indirect owners of the PFIC shares, at least for that year. *See generally* F.S.A. 199952014 (Sept. 23, 1999) (rejecting the use of actuarial values to determine a trust beneficiary's proportionate ownership of shares owned by a trust for CFC purposes).

d. Such an approach should dovetail with the general Subchapter J rules. Under those rules, the current portion and pre-PFIC portion of an excess distribution would be included in DNI and carried out to the income beneficiaries. *See* IRC § 661(b). The portion of the excess distribution allocated to previous years, however, will not be included in DNI for the reasons discussed above. That portion will be accounting income, so to the extent that accounting income is distributed to U.S. beneficiaries, those beneficiaries should receive some of that portion of the excess distribution under the character rule of IRC § 661(b). Thus, it makes sense to treat those beneficiaries as indirectly picking up a pro-rata share of the noncurrent portion of the excess distribution. This result would be consistent with the general principles of Subchapter J because the beneficiaries did in fact receive the PFIC dividend and, therefore, enjoyed the benefit of the deferral of U.S. income tax made possible by the trust's investment in the PFIC.

e. The relevance of the CFC indirect ownership rules to the PFIC indirect ownership rules, however, breaks down when a foreign trust sells or otherwise disposes of PFIC shares. The PFIC rules generally treat a disposition of PFIC shares as an excess distribution to the extent the taxpayer realizes a gain on the disposition. IRC § 1291(a)(2). If a U.S. person indirectly owns PFIC shares, IRC § 1298(b)(5) provides that "under regulations" the U.S. person will be deemed to have disposed of the shares. Putting aside the fact that there are no regulations applying IRC §

1298(b)(5) to trust beneficiaries, an attempt to apply the principles of the CFC indirect ownership rules in the case of a trust's disposition of PFIC shares does not work well.

f. The indirect ownership facts and circumstances test of Treas. Reg. § 1.958-1(c)(2) focuses on who receives the income from a foreign trust to determine indirect ownership. *See generally* Treas. Reg. § 1.958-1(c)(2). If a foreign trust disposes of PFIC shares and makes a distribution that would otherwise carry out the gain, then the analogy to the CFC indirect ownership rules works; the beneficiaries effectively received the benefit of the deferral when they received a cash distribution from the trust.

g. If, however, the trustee does not distribute the gain realized on the disposition of the PFIC shares, the application of the PFIC indirect ownership rules using the facts and circumstances described in Treas. Reg. § 1.958-1(c)(2) becomes much more difficult. The receipt from the disposition of the PFIC shares will be trust accounting principal. In the case of a discretionary trust, treating the trust's beneficiaries as owning the PFIC shares for purposes of imposing the excess distribution tax on the disposition seems unfair because those beneficiaries would have no legal right to receive the principal. Putting aside that inconvenience, how would such a beneficiary determine his or her deemed holding period for purposes of computing the deferred tax and interest charge? Using the trust's holding period might be a way to do this, but that does not take account of the fact that the trust may have never made distributions to the beneficiary in previous years, the fact that the beneficiary may not have been born during the trust's holding period, or the fact that the beneficiary may have been added as a beneficiary during the trust's holding period. By contrast, if a U.S. taxpayer indirectly owned PFIC shares through a foreign partnership or foreign corporation, his or her holding period would be relatively easy to determine; it would be the taxpayer's holding period for the shares of the foreign corporation or the partnership.

h. TAM 200733024 illustrates the difficulties of applying the indirect ownership rules based on the CFC facts and circumstances test when a trust disposes of PFIC shares but does not distribute the proceeds of sale to the trust beneficiaries. In TAM 200733024, a foreign trust, referred to in the TAM as "Fund B," liquidated a PFIC, which meant that the trust had a notional excess distribution for purposes of the PFIC rules. Fund B's beneficiaries were the five children of one of the children of the settlor; none of the children were U.S. citizens or residents. Only two of the children, Child H and Child I, themselves had children during the years involved in the TAM, and only Child I's children were U.S.

citizens or residents. Although Fund B benefited five grandchildren and their families, the TAM indicates that the trustees had made distributions during the years in question only to the children of Child H and Child I; apparently the trustees did not make any distributions to the three other trust beneficiaries. According to the IRS, the trustees "historically" had made distributions in equal amounts between the children of Child H and the children of Child I.

i. Although the facts of the TAM are not entirely clear, it appears that two of the beneficiaries of Fund B who had not previously received distributions but were likely to have children (apparently the fifth beneficiary was not likely to have children) renounced their interests and their potential children's interests in Fund B. Child I and Child H also apparently renounced their interests in Fund B, leaving only the children of Child I and the children of Child H as the beneficiaries of Fund B. Following this series of renunciations, the trustees of Fund B liquidated the PFIC and in the same year distributed the accrued income of Fund B and a portion of the principal of Fund B to a separate non-U.S. trust established for the benefit of children of Child H, none of whom were U.S. citizens or residents. The total amount distributed to this trust was about 50% of Fund B's total assets (accrued income and principal). In the following year the trustees distributed the balance of the property of Fund B to a U.S. domestic trust administered for the benefit of the children of Child I, all of whom were U.S. citizens or tax residents. The trustees of this new trust did not make any distributions to the children of Child I, so no individual U.S. citizen or resident received a distribution of income or principal of Trust B following the PFIC liquidation.

j. Among other things, the taxpayers argued that the distribution to the non-U.S. trust for the children of Child H, who were not U.S. citizens or residents, in the year of the PFIC disposition event carried out the DNI of Fund B along with the notional excess distribution to the non-U.S. trust, leaving only principal in Fund B. The taxpayers took the position that the distribution in that year to the non-U.S. trust "cleansed" Fund B of the notional excess distribution, leaving only principal to be distributed to the U.S. trust for the benefit of the children of Child I in the succeeding year. According to the taxpayers, no excess distribution remained in Fund B in the succeeding year because of the distribution to the trust for the benefit of the children of Child H in the preceding year. Because of the timing of the distributions, the taxpayers argued that the non-U.S. trust ended up with the excess distribution and the U.S. trust ended up with principal. The TAM indicates that there was a disagreement between the taxpayers and the IRS

as to whether Fund B was a grantor trust. This disagreement was very fact-specific, and a discussion of the issues is beyond the scope of this outline's focus on indirect ownership rules. If the trust had been a grantor trust as to a nonresident alien, the PFIC issues should not have arisen.

k. The taxpayers pointed out to the IRS that this result was consistent with the general rules of Subchapter J and its DNI principles:

> Taxpayers argue that their adopted method of applying the trust distributable net income ("DNI") rules to preserve the PFIC excess distribution at the trust level and carry it out upon a subsequent distribution from the trust to the foreign beneficiaries is one such reasonable manner. Under Taxpayers' DNI method, the entire amount of the excess distribution resulting from the gain on the liquidating distribution from Corp J would have been carried out to the beneficiaries of Trust 5, along with all of the DNI of Fund B, on Date 28 when Fund B advanced half of its assets to Trust 5. Since Trust 5 has no U.S. beneficiaries, the excess distribution would result in the imposition of no PFIC tax. The distribution of the other half of the assets from Fund B to Trust 4 in the following year, on Date 32, would correspondingly result in no PFIC tax as there would be no excess distribution amount remaining in that year.
>
> Taxpayers point specifically to the reference to subchapter J in the preamble to the proposed section 1291 regulations. Taxpayers argue that, since DNI is an integral part of the taxation of trusts and beneficiaries under subchapter J and since the utilization of the DNI rules results in the preservation of tax at the trust level in the form of DNI, their method is a reasonable manner of applying section 1298(b)(5).

l. The IRS, however, thought that the taxpayers' approach was unreasonable because it did not preserve the excess distribution tax scheme and the interest charge:

> It is the Service's position that Taxpayers' DNI approach is unreasonable because it fails to actually preserve any of the PFIC interest charge. To the contrary, it facilitates the avoidance of the interest charge altogether by allowing the entire excess distribution amount to be carried out to foreign beneficiaries who are not subject to the PFIC regime. The purpose of section 1298(a)(3) and (b)(5) is to insure that the PFIC tax is not circumvented by the

imposition of a foreign pass-through entity such as a partnership or trust in an ownership chain between a U.S. person and a PFIC. Taxpayers' method of applying section 1298(b)(5) would make a trust with both U.S. and foreign beneficiaries an effective vehicle for circumvention of the PFIC regime because the PFIC tax and interest charge could be carried out to the foreign beneficiaries by manipulating the time of distributions from the trust, as Taxpayers have done here. Taxpayers' method represents neither a reasonable nor a good faith attempt to implement the statute in light of its language and purpose.

m. Probably realizing the strength of the taxpayers' Subchapter J argument, the IRS decided to take a back-door approach by deeming the children of Child I to have indirectly owned 50% of the assets of Fund B at the time of the PFIC liquidation, thereby allowing the IRS to tax those children of Child I on one-half of the deemed excess distribution under IRC § 1298(b)(5). The IRS pointed out that in the years preceding the PFIC liquidation, the trustees of Fund B had historically made distributions to the children of Child H and Child I in equal amounts and that certain documents described the settlor's intention that the benefits of Fund B be split between those two branches of the family on a 50-50 basis. In its analysis of the distributions from Fund B the IRS did not mention the fact that for most of the years in question there were actually three other beneficiaries of Fund B; the IRS focused only on the distributions the trustees made to the children of Child H and the children of Child I. According to the IRS, these facts and circumstances meant that the children of Child H and the children of Child I should each be deemed to own 50% of the trust-owned PFIC under the indirect ownership rules of IRC § 1298(a)(3). Although the IRS acknowledged that the trustees of Fund B made a distribution to a trust for the benefit of the U.S. beneficiaries ("Trust 4"), the IRS treated the beneficiaries themselves, and not Trust 4, as the indirect owner of the PFIC shares. Because of the deletion of the dates, it is unclear from the TAM whether Trust 4 was in existence on the date of the PFIC liquidation. If Trust 4 was in existence on the date of the PFIC liquidation, it, rather than the children of Child I, should have been treated as the indirect owner of the PFIC shares if the indirect ownership rules applied at all.

n. From an academic perspective, the IRS's reliance on of the facts and circumstances approach used in the CFC indirect rules to the PFIC indirect ownership rules is sensible because both sets of rules have the same purpose: to penalize tax deferral through the use of foreign corporations. In TAM 200733024, however, the IRS did

not apply the CFC-based facts and circumstances test in a reasonable manner. The CFC indirect ownership rules follow trust distributions to identify proportions in which the beneficiaries of a foreign trust should be deemed to indirectly own the trust's shares. *See* Treas. Reg. § 1.958-1(c)(2). To the extent the IRS wants to rely on the facts and circumstances test used in the CFC indirect ownership rules for PFIC purposes, the IRS should similarly focus on who receives distributions from a trust to determine the indirect owners of the trust's PFIC shares, if any.

o. If the facts in TAM 200733024 had involved a dividend paid by the PFIC that was an excess distribution, the CFC indirect ownership rules would suggest that the beneficiaries who received a distribution from the trust in the year the trust received the dividend should be treated as indirectly having received an excess distribution. The TAM, however, involved the liquidation of the PFIC, the proceeds of which were presumably allocable to principal for fiduciary accounting purposes. It was unreasonable for the IRS to say that the children of Child I should be deemed to own one-half of the entire trust principal when principal had not distributed to them and would not necessarily ever be distributed to them. In fact, the distribution from Fund B was made to Trust 4, not the children of Child I. The children of Child I had never received substantial principal distributions from Fund B, and there was no suggestion that the trustees would or could distribute one-half of the entire principal of Trust 4 to the children. In fact, it appeared there were three other grandchildren of the settlor who were beneficiaries of Fund B for most of the years in question. The trustees of Fund B could have distributed income and principal to any of the beneficiaries, including the non-U.S. beneficiaries and the grandchildren who did not yet have any children, in any portions the trustees wished. The trustees apparently chose not to make any distributions to these beneficiaries, which indicates the discretionary nature of Fund B. The children of Child I apparently had no vested right to receive principal from Fund B, and had no ability to compel the trustees to distribute principal to them. Furthermore, the proceeds of the liquidation were distributed to Trust 4, not to the children of Child I. In light of these facts, deeming those beneficiaries to own and control one-half of proceeds of the liquidation of the PFIC was unreasonable.

p. One way to test the reasonableness of the IRS's application of the facts and circumstances test in TAM 200733024 is to determine whether the tax result to the U.S. beneficiaries would be the same if the trustees of Fund B had invested the trust assets in the trust's name rather than through a holding company. Assume, for example, that instead of making passive investments through a

PFIC, the trustees of Fund B purchased and sold investment assets in the trust's name but never distributed any of the realized capital gain to the trust beneficiaries. Under Subchapter J, the realized gains would be part of DNI in the year in which the trustees realized the gain. To the extent that the trustees did not distribute the gain in that year, the gain would become part of UNI. *See* IRC § 665(a).

q. If the trustees later distributed trust principal to Fund B's nonresident alien beneficiaries, the distribution would carry out that UNI and any DNI from the year of the distribution to those beneficiaries as long as the separate share rule of IRC § 663(c) did not apply. If the separate rule applied, then 50% of the realized gains would be allocated to the children of Child H and 50% to the children of Child I. *See generally* IRC § 663(c); Treas. Reg. § 1.663(c)-1(a). Under the separate share rule of IRC § 663(c), a trustee of a trust with more than one beneficiary must allocate DNI pro rata among the trust beneficiaries to the extent that the trust instrument provides for substantially independent and separate shares for the beneficiaries. For example, if a trust instrument provides for the payment of the trust income in equal shares to three beneficiaries, those beneficiaries have separate and independent shares. In that situation, the separate share rule requires the trustee to effectively treat the shares as separate trusts for purposes of allocating DNI, even though the trustee files only one income tax return. If, however, the trustees did not make any distributions to the children of Child I, they would not be currently taxed on that realized gain. Instead, the gain would have become UNI, and a later distribution to those beneficiaries or a U.S. trust for their benefit could have carried out the UNI as an accumulation distribution. *See* IRC § 665(b) (defining an accumulation distribution). The taxpayers in the TAM argued that IRC § 667(b) would have achieved the same result as the application of the excess distribution regime because the PFIC distribution would have lost its character once it became UNI and would have been subject to the accumulation distribution tax and interest charge when later distributed to a U.S. taxpayer, whether a trust or an individual. Thus, the application of the Subchapter J rules would have been roughly consistent with the PFIC rules. As discussed above, however, it is unclear whether the prior years' portion of a PFIC excess distribution can ever be part of UNI given the fact that the prior years' portion is not technically includable in DNI. Whether or not the separate share rule applied, however, the U.S. beneficiaries would not pay any tax unless the trustees made a distribution to them.

r. For example, if the trustees of Fund B had a $1 million gain in 2006 and distributed $1 million to the children of Child H or a foreign trust for their benefit and the separate share rule did not apply, the distribution would carry out all the gain to those beneficiaries. If in 2007 the trustees distributed $1 million to a the children of Child I or a U.S. trust for their benefit, there would be no basis on which the IRS could argue that the children of Child I or the trust should be taxed on half of the gain from 2006 unless the separate share rule applied to Fund B. If, however, the separate share rule applied, then the 2006 distribution would have carried out only $500,000 of the gain to the children of Child H, leaving $500,000 of the gain to be allocated to the share of DNI allocable to the children of Child I, where it would have become UNI, thereby attracting a throwback tax and interest charge on the distribution in the next year. The U.S. beneficiaries or a trust for their benefit, however, would not be taxable in 2006 on 50% of the realized gain.

s. The TAM indicates that the taxpayer and the IRS disagreed about the potential application of the separate share rule to Fund B, which would have been an issue if the PFIC indirect ownership rules did not apply. The taxpayers argued that because Fund B was a discretionary trust, the separate share rule did not apply to Fund B. The separate share rule, however, does not apply to a discretionary trust under which the trustee can select among a class of beneficiaries to whom to distribute income and principal. The taxpayers provided evidence of the law of the country in which the trust was organized, including an opinion of counsel, to support its position. The IRS, however, stated that the taxpayers and their counsel were wrong in their interpretation of the trust agreement and of the applicable foreign law. According to the IRS, Fund B was not a discretionary trust within the context of the separate share rule, and that there were two separate and independent shares, one for the children of Child H and one for the children of Child I.

t. Whether or not the separate share rule applied to Trust B in the year of the PFIC liquidation is not particularly important to answering the question of whether the tax result in the TAM would have been the same under Subchapter J if the trustees of Fund B directly invested the trust assets instead of through a company. The application of the PFIC indirect ownership rules would cause a tax whether or not the trustees of Fund B made a distribution to the children of Child I or a trust for their benefit. If the trustees of Fund B had made the trust investments directly, the taxability of the children of Child I or the U.S. trust for their benefit on the gain would depend on whether and when the trustees of Fund B

distribution made a distribution to the children or the trust. If the trustees of Fund B did not make such a distribution, no U.S. tax would be owed, which is the critical difference between the PFIC indirect ownership rules and Subchapter J. Because the PFIC indirect ownership rules would result in taxation without any distributions in this situation, the application of those rules would conflict with Subchapter J and produce an unreasonable result.

u. The legislative history of the PFIC rules shows the importance of applying the PFIC rules in a way that reaches the same result as the Subchapter J rules. An important purpose of the PFIC rules was to discourage U.S. investors from obtaining advantages through the investment in a foreign passive investment company that was not a CFC:

> The committee is concerned that U.S. persons who invest in passive assets through a foreign investment company obtain a substantial tax advantage vis-à-vis U.S. investors in domestic investment companies because they avoid current taxation and are able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain income. The committee does not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. In the committee's view, U.S. persons who invest in passive assets should not be able to achieve tax deferral just because they invest in those assets indirectly through a foreign corporation.

Senate Finance Committee Rep. No. 99-313 on the Tax Reform Act of 1986 (H.R. 3838) at 393-94 (reprinted at 1986-3 C.B. 393-94). The PFIC rules, accordingly, attempt to roughly mimic the tax results that a U.S. investor would have if he or she directly invested in assets rather than through a foreign corporation. In TAM 200733024, however, the IRS applied the PFIC indirect ownership rules in a way that would result in considerably different – and worse – treatment than would have occurred had the trustees of Fund B invested directly in the trust's name. If the trustees of Fund B had owned the investment assets directly, there would be no question that the children of Child I or a trust for their benefit would not have been taxable on 50% of the notional gain incurred in the liquidation of the company in the year in which the company was liquidated. It is possible that the children of Child I or the trust for their benefit would be required to pay a throwback tax on a distribution from Fund B in a later year, but such a distribution would be a prerequisite to U.S. taxation. The IRS's

approach in the TAM produced much more onerous tax results than a direct investment by Fund B, which is an unreasonable result.

v. The IRS and the taxpayer have settled the controversy described in the TAM, so the courts will not have an opportunity to weigh in the reasonableness of the IRS's approach to the application of the PFIC indirect ownership rules in the TAM. Tax advisers and their clients, however, should keep in mind that the IRS's position in the TAM is nothing more than an articulation of its likely position in litigation. Under IRC § 6110(k)(3), the TAM is not citable as authority. Rather, like a proposed regulation, the TAM is nothing more than a statement of a frequent litigant and is not entitled to any judicial deference. *See, e.g., Lagia v. Commissioner*, 88 T.C. 894, 897 (proposed regulations carry no more weight in court than a position advanced on brief). Taxpayers should not concede the application of the PFIC indirect ownership rules in the manner suggested by the IRS in TAM 200733024.

H. *Compliance Issues*

1. Before the 2013 tax year, a direct or indirect U.S. shareholder in a PFIC who had not made a QEF election or mark to market ("MTM") election was required to file an IRS Form 8621 for a year in which the taxpayer received a distribution from the PFIC or recognized gain on the disposition of shares in the PFIC. If a shareholder of such a PFIC did not receive a distribution from the PFIC in a given year, the shareholder was not required to file Form 8621 for the year. On the other hand, a U.S. shareholder of a PFIC who had made a QEF election or MTM election with respect to the PFIC was required to file a Form 8621 for each year in which the election was in place.

2. In March 2010 Congress enacted a new statute, IRC § 1298(f), which requires every shareholder in a PFIC to file an informational return with the IRS in a form and with information that the IRS decides is appropriate. The IRS, however, suspended the filing requirement for a number of years. *See* IRS Notice 2011-55, 2011-29 I.R.B. 53. In that notice, the IRS indicated that once it revised Form 8621 to pick up the legislative change to IRC § 1298(f), taxpayers would have to file the form for the years in which the filing requirement had been suspended.

3. In 2012 the IRS issued a revised Form 8621 that picked up the legislative change, and issued a draft Form 8621 for 2013 that retained the revisions. The 2012 Instructions to the Form 8621 provided that until the government issued regulations, however, taxpayers did not have to complete that particular part of the form.

4. In December 2013 the IRS issued temporary regulations under IRC § 1298(f) that implemented the requirement that taxpayers who own shares in PFICs report that ownership on Form 8621 even if a taxable event does not occur with respect to the shares. The filing requirements apply for the 2013 tax year and future years. Temp. Treas. Reg. § 1.1298-1T(d). Happily for taxpayers, the IRS eliminated the requirement that taxpayers file Form 8621 for the tax years in which the IRS had previously suspended the filing requirement in IRS Notice 2011-55. Temp. Treas. Reg. § 1.1298-1T(c)(3).

5. Under the temporary regulations, a taxpayer who directly or indirectly owns shares in a PFIC for which a QEF or MTM election has not been filed must disclose the ownership of those shares to the IRS on a timely filed Form 8621 even if a taxable event has not occurred with respect to the taxpayer's PFIC shares. *See* Temp. Treas. Reg. § 1.1298-1T(b)(1). If, however, the value of the taxpayer's shares in a particular PFIC is less than $25,000 and the shareholder did not receive an excess distribution, the taxpayer need not file the form with respect to that PFIC. Temp. Treas. Reg. § 1.1298-1T(c)(2)(i)(A)(1). If the taxpayer is married and files a joint return, the filing threshold increases to $50,000 in value per qualifying PFIC. *Id.* The filing threshold is increased to $50,000 when a shareholder indirectly owns shares in a PFIC through another PFIC.

6. The new filing requirements generally apply to domestic estates and nongrantor trusts as well as to U.S. taxpayers who own the income of trusts under the grantor trust rules. The IRS also issued temporary regulations that require U.S. beneficiaries of domestic trusts that own shares in a PFIC for which a QEF or MTM election is made to file Form 8621 if the trustee fails to file the form. *See* Temp. Treas. Reg. § 1.1298-1T(b)(2)(ii). The temporary regulations also require a U.S. citizen or resident beneficiary of a foreign trust or foreign estate to file Form 8621 for each PFIC for which the trustee or personal representative has made a QEF or MTM election. *See* Temp. Treas. Reg. § 1.1298-1T(b)(3)(iii). A U.S. citizen or resident beneficiary of a domestic or foreign trust or estate must file Form 8621 for years in which the beneficiary is deemed to have received an excess distribution. Temp. Treas. Reg. § 1.1298-1T(b)(2)(i).

7. A shareholder must file a separate Form 8621 for each PFIC in which he or she owns shares. Temp. Treas. Reg. § 1.1298-1T(e). Form 8621 is due at the same time a taxpayer's individual income tax return is due and must be filed with the taxpayer's individual income tax return. Temp. Treas. Reg. § 1.1298-1T(d).

XII. Ownership of Interests in Controlled Foreign Partnerships

A. *Introduction.*

1. Extra compliance rules apply to U.S. citizens and residents who "control" foreign partnerships. A U.S. person will be deemed to "control" a foreign partnership if he or she directly or indirectly owns more than a 50% interest in the partnership. Code § 6038(e)(3)(B) describes a 50% interest as either an interest equal to 50% of the capital of the partnership, an interest in 50% of the partnership's profits, or, as provided in regulations, an interest to which 50% of the partnership's deductions or losses are allocated.

2. Even if a U.S. person does not "control" a foreign partnership, he or she may be subject to extra compliance obligations if he or she holds a 10% or greater interest in a foreign partnership that is controlled by U.S. persons who own 10% of greater interests. *See* IRC § 6038(a)(5)(giving the IRS authority to require 10% partners to file an informational return); Treas. Reg. § 1.6038-3(a)(2)(implementing reporting requirements). For purposes of this reporting requirement, "control" by 10% partners means that the 10% partners together own more than a 50% interest in the partnership. *See* IRC § 6038(e)(3)(C)(referring to IRC § 6038(e)(3)(B)); Treas. Reg. § 1.6038-3(b)(1).

3. For purposes of the 10% reporting rules, a 10% interest is an interest equal to 10% of the capital interest in the partnership, an interest equal to 10% of the profits of the partnership, or an interest to which 10% of the partnership's deductions and losses are allocated. Treas. Reg. § 1.6038-3(b)(3).

4. Unlike the CFC and PFIC rules, the controlled foreign partnership reporting rules are not substantive tax rules; they are only compliance rules. Under the general principles of Subchapter K, a U.S. citizen or resident owner of an interest in a foreign partnership must already include his or her share of the foreign partnership's income, gain, loss, and deductions in his or her income.

5. The constructive ownership rules of IRC § 267(c), other than IRC § 267(c)(3), apply to determine when U.S. citizens and residents are deemed to own interests in partnerships for purposes of the IRC § 6038 reporting requirements. Treas. Reg. § 1.6038-3(b)(4).

   a. The effect of the constructive ownership rules means that an individual will be deemed to own interests in a foreign partnership owned by members of his or her "family." IRC § 267(c)(2). A member of an individual's "family" for purposes of IRC §

267(c)(2) is the individual's spouse, siblings, ancestors, and descendants. IRC § 267(c)(4).

b. The regulations, however, provide that an interest of a nonresident alien in a foreign partnership will not be attributed to a U.S. member of that alien's family unless that U.S. family member directly or indirectly owns an interest in that partnership. Treas. Reg. § 1.6038-3(b)(4). In other words, a U.S. taxpayer will not be subject to the reporting requirements simply because a nonresident alien member of the taxpayer's family owns an interest in a foreign partnership.

c. A U.S. beneficiary of a foreign trust or foreign estate may be deemed to own a proportionate share of the trust's or estate's interest in a foreign partnership.

(i) Under IRC § 267(c)(1), an interest owned by an estate or trust will be considered as owned proportionately by its beneficiaries. The IRS, however, has not issued any regulations under IRC § 267(c)(1) that explain how to apply the proportionate ownership rule.

(ii) Applying the proportionate ownership rule to an estate should be fairly straightforward as it is in the CFC and PFIC indirect ownership rules, i.e. based on the beneficiaries' proportionate interests in the decedent's estate.

(iii) Applying the proportionate ownership rule to trusts, however, is more difficult due to a lack of guidance from the courts and the IRS. In PLR 9015055, for instance, the IRS ruled that an individual and her children, who were beneficiaries of a trust that owned shares, were deemed to own the shares under IRC § 267(c)(1). The IRS, however, did not discuss how to apportion the shares among the trust beneficiaries. *See also Liflans Corp. v. United States*, 390 F.2d 695 (Ct. Claims 1968) (court concludes that beneficiaries of a trust deemed to own trust's shares under IRC § 267(c) without any discussion of the basis on which the proportionate ownership rules were to be applied); P.L.R. 8128073. About the most we can tell from the cases and rulings is that even contingent interests do count for purposes of IRC § 267(c) but we do not know how to count them. *E.g.*, *Wyly v. United States*, 662 F.2d 397 (5th Cir. 1981); *Widener Trust No. 5 v. Commissioner*, 80 T.C. 304 (1983).

(iv) In *Hickman v. Commissioner*, T.C. Memo. 72-208, 31 T.C.M. 1030 (1972), the Tax Court held that actuarial values cannot be used to apply the proportionate ownership rules for trust beneficiaries under IRC § 267(c)(1). In *Hickman*, the taxpayer challenged the IRS's method of computing proportionate ownership, but failed to convince the court that the IRS was incorrect. The taxpayers first suggested that actuarial values should be used to determine their proportionate interests in the trust's shares, but the court found no support for this approach in the legislation and its history. The court also rejected the taxpayers' suggestion that the value of their interests in the shares owned by the trust was zero because they could not assign their interests in the trust. The court, however, did not describe how the IRS applied the proportionate ownership test other than referring to an IRS conclusion that the taxpayers owned more than 50% of the value of the shares because the taxpayers were the only present beneficiaries of the trust and because the trust had no specifically named remainder beneficiaries.

B. *IRC § 6046A Reporting.*

1. Under IRC § 6046A a U.S. taxpayer must file an informational return when:

a. The U.S. person acquires or disposes of an interest in a foreign partnership if the U.S. person owns at least a 10% interest in the partnership either before or after the acquisition or disposition. IRC §§ 6046A(a)(1), 6046A(a)(2).

b. The U.S. person's proportionate interest in a foreign partnership changes "substantially." This reporting requirement applies only if a change is equivalent to at least a 10% interest in the partnership. IRC § 6046A(a)(3). Under the regulations, a partner's proportional interest in a foreign partnership may change for a number of reasons:

> [F]or example, the change may be caused by changes in other partners' interests resulting from a partner withdrawing from the partnership. A proportional change may also occur by operation of the partnership agreement, for example, if the partnership agreement provides that a partner's interest in profits will change on a set date or when the partnership has earned a specified amount of profits and one of those events occurs.

Treas. Reg. § 1.6046A-1(b)(3).

2. Section 6046A relies on the definition of a 10% partnership interest used in IRC § 6038(e)(3)(C).

3. Under IRC § 6046A, reporting of an event is required only when it changes a *direct* interest that the U.S. taxpayer has in a foreign partnership. Even though IRC § 6046A suggests its rules apply to U.S. taxpayers who indirectly own interests in foreign partnerships, the regulations provide that the reporting requirements do not apply to transactions that involve interests in partnerships that the U.S. person might indirectly own under the principles of IRC § 6038(e)(3)(C). *See* Treas. Reg. § 1.6046A-1(b)(1); Treas. Reg. § 1.6046A-1(b)(7), Example 1.

C. *Compliance Obligations*

1. A U.S. citizen or resident who is required to report information about a controlled foreign partnership does so on IRS Form 8865.

2. A U.S. taxpayer who "controls" a foreign partnership under the 50% test is a Category 1 filer for Form 8865 purposes. A U.S. taxpayer who owns a 10% interest in a controlled foreign partnership is a Category 2 filer. A Category 3 filer is a U.S. person who made a capital contribution to a foreign partnership in a particular year with the result that he or she owned directly or constructively at least a 10% interest in the partnership immediately after the contribution. Category 3 also includes U.S. taxpayers who contributed property with a value of more than $100,000 in a 12-month period, without regard to that taxpayer's proportionate ownership. Finally, a Category 4 filer is a U.S. taxpayer who had an event with respect to the partnership that must be reported under IRC § 6046A.

3. In general, any U.S. citizen or resident who owns more than a 10% "controlling" interest in a foreign partnership must file an IRS Form 8865. If, however, the foreign partnership has a U.S. citizen or resident who is a 50% controlling partner, then the 10% partners are not required to file Form 8865. Instead, the government will rely on the Form 8865 filed by the 50% partner to collect the information the government needs.

4. A Category 1 or 2 filer is not required to file a Form 8865 if the partnership itself files an IRS Form 1065 or 1065-B for its tax year. Instead, the Category 1 or 2 filer can use a copy of the partnership's return in lieu of the Form 8865.

XIII. Income Tax Issues When a U.S. Taxpayer Receives a Gift from a Nonresident Alien

A. *Introduction*

1. A U.S. citizen or resident who receives a gift from a nonresident alien donor is generally not subject to federal income tax on the gift. *See* IRC § 102 (excluding gifts from gross income).

2. A U.S. citizen or income tax resident, however, must report the receipt of a gift from a nonresident alien to the IRS on an IRS Form 3520. *See generally* IRC § 6039F (reporting required for gifts received from a person "other than a United States person" (referring to IRC § 7701(a)(30)). Filing a Form 3520 in and of itself does not give rise to any tax obligations on the donee.

3. Section 6039F requires a U.S. person to report gifts from nonresident aliens if the aggregate amount of gifts received in a given calendar year exceeds $10,000. The IRS, however, increased the minimum reportable amount for aggregate gifts from nonresident alien individuals to $100,000 in Notice 97-34, 1997-1 C.B. 422. The IRS left the $10,000 minimum amount for gifts from foreign corporations and partnerships, although the $10,000 threshold will be adjusted for inflation. In computing the amount of aggregate gifts received from a nonresident alien donor, a U.S. person must aggregate gifts from that donor and persons related to that donor for the calendar year in question.

B. *Taxation of Distributions from a Foreign Estate to a U.S. Beneficiary*

1. Introduction

   a. The simplest situation you may run into is when a client is the beneficiary of the estate of a nonresident alien, either by will or by intestate succession.

   b. The client's receipt of a bequest or devise of property from a nonresident alien should not be subject to tax by reason of IRC § 102. It is also likely that distributions from the estate will not carry out any DNI to your client if the estate does not have any U.S. source income.

   c. In certain situations, a revocable trust used by a deceased nonresident alien as a will substitute may be classified as a foreign estate, thereby bringing the benefits of a foreign estate to a foreign trust, at least for two years.

2. Classifying an Estate as Foreign or Domestic

   a. If your client is the beneficiary of an estate administered in a

country other than the U.S., that estate will be a foreign estate for U.S. income tax purposes. *See* IRC § 7701(a)(31)(A). It is possible, however, that an estate of a foreign decedent administered in the United States may also be a foreign estate for U.S. federal income tax purposes. If this is the case, the income tax consequences to a beneficiary of the estate are considerably different than if the estate was a domestic estate. Thus, this section of the outline goes through some of the definitional rules related to foreign estates for U.S. federal income tax purposes so you can identify whether your clients may be in this situation.

b. Although IRC § 7701(a)(31)(A) looks like it will define a foreign estate, it does not. Instead, it simply says that a foreign estate is an estate the U.S. source income of which is not effectively connected with a U.S. trade or business is not includable in the estate's gross income under Subtitle A. Congress, in a great demonstration of drafting skill, provided in IRC § 7701(a)(30)(E) that a domestic estate is any estate that is not a foreign estate as defined in IRC § 7701(a)(31). *See generally* Schoenblum, § 22.05[B] at 22-80 (IRC § 7701(a)(31)(A) is "a largely useless definition that begs the question . . . . In short, the Code has a built in circularity.").

c. The IRS has not promulgated any regulations on the definition of a foreign estate. As a result, the rules for classifying an estate as foreign or domestic have been developed in court decisions and revenue rulings. *See generally id.*

d. The IRS described the important facts and circumstances in the classification of an estate as domestic or foreign in Technical Advice Memorandum 9413005:

(i) the country under whose law the estate was created;

(ii) the residence or citizenship of the decedent;

(iii) the residence or citizenship of the beneficiaries;

(iv) the location of the estate assets;

(v) the residence of the executor; and

(vi) location of the administration of the assets.

The IRS cited *BOW. Jones Trust v. Commissioner*, 46 BETA. 531 (1942), *aff'd* 132 F.2d 914 (4th Cir. 1943), as the source of these factors.

e. Among these factors, one of the most important is the decedent's residence. *E.g.,* Rev. Rul. 81-112, 1981- C.B. 598 (estate of U.S. citizen who resided in a foreign country for 20 years before his death was a foreign estate); Rev. Rul. 64-307, 1964-2 C.B. 163 (estate of a U.S. citizen and resident that was administered in a foreign country was not a foreign estate). Thus, you can usually assume that your client is a beneficiary of a foreign estate if the decedent was resident in a country other than the United States.

f. It is possible, however, that the IRS could classify a foreign estate as a foreign trust if the estate has been under administration for a long time and more closely resembles a trust rather than an estate. *See, e.g.,* P.L.R. 9010046 (involving a German estate).

3. U.S. Federal Income Taxation of Distributions from Foreign Estates

a. A foreign estate is a nonresident alien for federal income tax purposes. Thus, it will be subject to U.S. income tax on income with a U.S. source or income effectively connected with a U.S. trade or business. *See, e.g.*, Rev. Rul. 68-621, 1968-2 C.B. 286; Rev. Rul. 62-154, 1962-2 C.B. 148; P.L.R. 8317020.

b. More important, however, is how the principles of Subchapter J apply to distributions from foreign estates to U.S. beneficiaries.

(i) As is the case with a domestic estate, a U.S. beneficiary of a foreign estate must include a pro rata share of the estate's DNI in his or her income when the estate makes a distribution to him or her. *See generally* IRC § 662.

(ii) A foreign estate's distributable net income or "DNI," however, does not include its non-U.S. source income. Section 643(a) generally provides that the DNI or an estate or trust is the trust's taxable income computed with certain modifications. A foreign estate's taxable income for U.S. purposes is only its U.S. source income. Foreign source income, including gains realized on the sale of U.S. intangible assets, would not be part of a foreign estate's taxable income. *E.g.*, P.L.R. 8317020. *See generally* IRC § 872(a). Although IRC § 643(a)(6) provides that a foreign *trust's* gross income includes non-U.S. source income and capital gains, the modification of that section does not apply to foreign estates. Accordingly, a foreign estate's DNI does not include foreign source income, including gains realized from the sale of U.S. intangible assets.

(iii) Because a foreign estate's DNI does not include its foreign source income, a distribution from the estate to a U.S. beneficiary will not carry out any foreign source income to the beneficiary. *See* IRC § 662(a). Thus, the U.S. beneficiary will have taxable income on account of receiving the distribution from the foreign estate only if the estate's DNI includes U.S. source income. *See* Zaritsky, "U.S. Taxation of Foreign Estates, Trusts and Beneficiaries" (T.M. Memo. 854) at A-129 ("while there are no cases or rulings on point, a clear reading of the Code and regulations compel this result").

(iv) The accumulation distribution tax or "throwback tax" does not apply to distributions from estates. *See* IRC § 665(b) (defining an accumulation distribution by references to trusts). Thus, a distribution from a foreign estate to a U.S. beneficiary will not attract the throwback tax, even if the foreign estate has accumulated income for a significant time period. It is possible, however, that the IRS may treat a long-term foreign estate as a foreign trust.

c. Certain revocable trusts can elect to be treated as foreign estates under IRC § 645.

(i) If a nonresident alien decedent held property in a revocable trust at his or her death, the trust may be able to make an IRC § 645 election to be treated as part of the nonresident alien's estate for federal income tax purposes. The final regulations under IRC § 645 do not limit the election to domestic trusts and estates. In fact, the IRS acknowledged in the preamble to the final regulations that a foreign trust could make the election as long as the trust was a "qualified revocable trust" or "QRT" within the meaning of IRC § 645(b)(1):

> The proposed regulations also provide that a QRT must be a domestic trust under section 7701(a)(30)(E) and that a section 645 election for a QRT must result in a domestic estate under section 7701(a)(30)(D). Several commentators suggested that the section 645 election should also be available in situations in which either the QRT or the related estate, or both, are foreign. According to the commentators, U.S. citizens living abroad frequently use revocable trusts to avoid jurisdictional

> disputes concerning the decedent's assets, as well as the cumbersome probate and forced heirship rules of several foreign countries. Many of the trusts will be foreign trusts upon the grantor's death and, if a section 645 election is permitted to be made, will become part of a foreign estate. The commentators questioned the authority for the domestic restriction provided in the proposed regulations given that the statute and the legislative history do not explicitly limit the applicability of a section 645 election to domestic trusts and domestic estates. Upon consideration of these comments, the requirements that a QRT be a domestic trust and that the election result in a domestic estate are removed from the final regulations. The IRS and the Treasury Department note, however, that a trust for which a section 645 election is made is treated as an estate for purposes of Subtitle A of the Code, but not for purposes of Subtitle F. Accordingly, information reporting under section 6048 will continue to apply with respect to a foreign trust even though a section 645 election has been made to allow the foreign trust to be taxed as part of an estate for purposes of Subtitle A of the Code.

T.D. 9032, 2003-7 I.R.B. 471. Consistent with this rule, IRS Form 8855, by which the IRC § 645 election is made, allows a foreign estate or foreign trust to make the election.

(ii) To make the election, a revocable trust established by a nonresident alien must have been treated as the owner of the assets of the trust for income tax purposes during his or her lifetime under IRC § 676 by reason of the decedent's retention of a power to revoke the trust. IRC § 645(b)(1). Under IRC § 672(f), however, many revocable trusts settled by nonresident aliens cannot claim grantor trust treatment for U.S. federal income tax purposes. Section 672(f) applies only when one of the other provisions of the Subpart E rules would make a trust a grantor trust. If a nonresident alien establishes a revocable trust that complies with IRC § 676 (without

regard to IRC § 672(e)) and also meets the requirements for grantor trust treatment under IRC § 672(f)(2)(A)(i), then the trust should be a qualified revocable trust for IRC § 645 purposes because IRC § 676 applied to treat the trust as a grantor trust; the effect of the trust's compliance with IRC § 672(f)(2)(A)(i) was that IRC § 676 would in fact apply to the trust.

(iii) The benefit of an IRC § 645 election for a revocable trust settled by a nonresident alien is that the trust's non-U.S. source income would not be included in its DNI for the effective period of the election. Thus, when the trust makes distributions to U.S. beneficiaries during that period, the distributions will not carry out any foreign source income to those beneficiaries. Furthermore, because the foreign source income is not includable in the trust's DNI, that income cannot become undistributable net income ("UNI"), which could give rise to a throwback tax if the trustee later makes an accumulation distribution.

(iv) To make the IRC § 645 election, the executor of the decedent's estate, if any, otherwise the trustee of the revocable trust, must file the appropriate forms with the IRS. *See generally* Treas. Reg. § 1.645-1(c). A foreign executor or trustee may be reluctant to file the necessary forms with the IRS if the trust will not have any U.S. source income.

(v) The length of the election will be two years after the date of the decedent's death unless the decedent's estate files an IRS Form 706, in which case the election will continue until six months after the final determination of the federal estate tax in the decedent's estate. If the six-month period concludes sooner than two years after the decedent's date of death, the two-year period applies. *See generally* Treas. Reg. § 1.645-1(f).

4. Compliance Obligations for U.S. Beneficiaries of Foreign Estates.

a. A U.S. citizen or income tax resident who receives a distribution from a foreign estate must report the receipt of a distribution to the IRS on an IRS Form 3520. *See generally* IRC § 6039F (reporting required for bequests received from a person "other than a United States person" (referring to IRC § 7701(a)(30)). Thus, a U.S. beneficiary who receives a bequest from a foreign decedent must report the receipt of the bequest, assuming that the beneficiary treats the distribution as a bequest under IRC § 102.

b. Section 6039F requires a U.S. person to report bequests from nonresident aliens if the aggregate amount of bequests received in a given calendar year exceeds $10,000. The IRS, however, increased the minimum reportable amount for aggregate gifts from nonresident alien individuals to gifts that exceed $100,000 in IRS Notice 97-34 1997-1 C.B. 422, § VI(B)(1).

c. The penalty for not reporting the receipt of a reportable bequest is 5% of the amount of the bequest for each month that the failure to report continues, subject to a limit of 25% of the total amount of the bequest. IRC § 6039F(c)(1). The IRS may waive the penalty for reasonable cause. IRC § 6039F(c)(2).

d. Section 6039F(b) applies to amounts received from a foreign person that the U.S. recipient treats as a gift or a bequest, which presumably is a reference to IRC § 102. If a foreign estate has no U.S. source income, a distribution from that estate to a U.S. person should be treated as a nontaxable bequest so IRC § 6039F generally requires the beneficiary to report the receipt of the bequest. If, however, the foreign estate had U.S. source income that would be taxable to the beneficiary under IRC § 662(a), the distribution is not technically a bequest from a foreign person to the U.S. person within the meaning of IRC § 102. This raises a question of whether the receipt of such a distribution is reportable under IRC § 6039F. The reporting requirements of IRC § 6048(c) apply only to distributions from foreign trusts.

e. In Notice 97-34 the IRS took the position that IRC § 6039F covered the receipt of a bequest from a foreign person to a U.S. person without addressing whether some or all of the bequest might be taxable under IRC § 662(a). The Instructions to IRS Form 3520 do not address how to report, if at all, a distribution from a foreign estate that the recipient does not treat as a bequest because of the presence of U.S. source income. If, however, a foreign trust that has made an IRC § 645 election makes a distribution to a U.S. person, the IRS takes the position that the distribution is reportable. *See* T.D. 9032, 2003-7 I.R.B. 471 (preamble to final IRC § 645 regulations).

XIV. Income Tax Issues for U.S. Beneficiaries of Foreign Trusts

A. *The Anti-Deferral Regime for Distributions from Foreign Nongrantor Trusts*

1. Distributions from foreign trusts to U.S. citizens and U.S. residents trigger potentially harsh U.S. income tax consequences irritating reporting requirements for the beneficiaries.

2. U.S. tax law generally treats distributions from foreign nongrantor trusts to U.S. beneficiaries in the same way it treats distributions from domestic nongrantor trusts to U.S. beneficiaries. The law takes this approach even though the trust in question is a nonresident alien and may not be subject to the U.S. taxing jurisdiction. To this extent, the rules of Subchapter J are deemed to apply to the foreign trust, rather than to actually apply.

3. Accordingly, applying general principles of Subchapter J, if a distribution from a foreign nongrantor trust would have carried out the trust's DNI to the U.S. beneficiary, then the U.S. beneficiary must include some or all of the trust's income in his or her individual income.

4. There is, however, a practical difficulty in applying this rule: the fiduciary of a foreign trust may not be subject to U.S. tax reporting rules or may not be familiar with those rules. As a result, the U.S. beneficiary may not know the nature and character of the amount she or she received from the trust.

5. In light of this practical difficulty, Congress and the IRS decided to treat all distributions from foreign trusts to U.S. beneficiaries as distributions from nongrantor trusts unless the beneficiary can demonstrate that the distribution was from a grantor trust. *See* IRC § 6048(c)(2).

6. In addition, Congress and the IRS presume that distributions from foreign trusts to U.S. persons are "accumulation distributions" that carry with them not only current income tax but also accumulated income, which could generate a penalty "throwback" tax. IRC § 6048(c)(2). Again, the burden is on the U.S. beneficiary to establish a more favorable tax treatment of the distribution.

7. To implement these rules, Congress and the IRS have imposed numerous reporting requirements for U.S. taxpayers who receive distributions from foreign trusts. The outline discusses those requirements in detail below.

B. *Classifying Trusts as Foreign or Domestic*

1. Introduction

a. Federal tax law classifies trusts as domestic trusts or foreign trusts. Domestic trusts present few unusual federal income tax issues. On the other hand, foreign trusts raise a number of complex substantive federal income tax issues and compliance obligations.

b. It is fairly easy for a trust to be a foreign trust. Under IRC § 7701(a)(31), a trust is a foreign trust if it is not a domestic trust. A trust is a domestic trust if (a) a court within the U.S. is able to exercise primary supervision over the administration of the trust and (b) if U.S. persons have the authority to control all substantial

decisions of the trust. IRC § 7701(a)(30)(E). *See also* Treas. Reg. § 301.7701-7. Thus, to be classified as a foreign trust, a U.S. court must not be able to exercise primary supervision over the administration of the trust or a non-U.S. person must have authority to control at least one substantial decision related to the trust.

c. The classification of a trust as foreign or domestic does not in and of itself determine the substantive tax rules that apply to the trust, its grantor, and its beneficiaries. Rather, a number of special rules within Subchapter J apply to foreign trusts, so you have to know how to classify the trust in order to determine whether those special rules apply. The classification of a trust as foreign or domestic also determines the compliance rules that apply to the trust, its grantor, and its beneficiaries; the compliance rules that apply to a foreign trust are much more onerous than the rules that apply to a domestic trust.

2. Court Test

a. To be classified as a domestic trust, a court within the United States must be able to exercise primary supervision over the administration of the trust (the "court test"). IRC § 7701(a)(30)(E)(i). According to the regulations, a court is "able to exercise" primary supervision if the court would have authority to render orders or judgments concerning the trust. Treas. Reg. § 301.7701-7(c)(3)(iii). Under the regulations, the term "primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. A court may have primary supervision even if another court has jurisdiction over a trustee, a beneficiary, or trust property. Treas. Reg. § 301.7701-7(c)(3)(iii). If both a U.S. court and a foreign court are able to exercise primary supervision of the trust, the trust will meet the court test. Treas. Reg. § 301.7701-7(c)(4)(i)(1).

b. The legislative history of IRC § 7701(a)(30)(E) indicates that Congress expected the court test "generally will be satisfied by any trust instrument that specifies that it is to be governed by the laws of any State." House Committee Report on H.R. 3286 (P.L. 104-188 – Small Business Job Protection Act of 1996), *reprinted in* 1996 Tax Legislation: Law and Explanation at 675 (CCH 1996). Under the House's view of the statute, a trust would pass the court test as long as the trust instrument provides that the law of one of the states of the United States governs the trust.

c. The Treasury Regulations under IRC § 7701(a)(30)(E), however, take a more restrictive view of the court test: "[T]he terms of the trust instrument *and applicable law* must be applied to determine whether the court test . . . [is] met." Treas. Reg. § 301.7701-7(b) (emphasis added).

d. The regulations provide examples of when a trust will meet the court test:

   (i) In case of a lifetime trust, if the trust registers in a Uniform Probate Code ("UPC") jurisdiction that provides for registration of trusts. *See* UPC § 7-101.

   (ii) If the beneficiaries and fiduciaries take steps with a court within the U.S. that cause the administration of the trust to be subject to the primary supervision of the court.

   (iii) A testamentary trust will meet the court test if a U.S. court has qualified all the trustees.

   See Treas. Reg. § 301.7701-7(c)(4)(i)(A)-(D). The relatively new Uniform Trust Code ("UTC") did not include a registration provision similar to UPC § 7-101, leaving it to the states that adopt the UTC to either retain UPC § 7-101 when the state replaces Article 7 of the UPC with the UTC or to enact UPC § 7-101. *See* 7C Uniform Laws Ann. (2005 Supp.) at 179. Several states have adopted or retained the trust registration. *See e.g.*, Alaska. Stat. § 13.36.005; Hawaii Rev. Stat. § 560:7-101; Idaho Code § 15-7-101; Ky. Rev. Stat. § 386.655; Mich. Comp. Laws § 700.7209; Mo. Rev. Stat. § 456.027; Neb. Rev. Stat. § 30-3816.

e. In drafting regulations to implement the court test, the IRS realized that it often be difficult to determine "whether the court of a particular state would assert primary supervision over the administration of a trust if the trust had never appeared before a court." Preamble to Proposed Regulations Under IRC § 7701(a)(30)(E), 1997-25 I.R.B. 5, 5. Many states do not provide for routine court supervision of lifetime trusts or testamentary trusts. Furthermore, many non-UPC states do not provide for a mechanism by which the trust's fiduciaries and beneficiaries could simply submit the trust to the jurisdiction of a court in that state when there is no case or controversy involving the trust.

f. To address this problem, the IRS provided a "safe harbor" for trusts to satisfy the court test. If a trust meets all of the following criteria, it will automatically satisfy the court test:

(i) The trust instrument does not direct that the trust be administered outside of the United States;

(ii) The trust in fact is administered exclusively in the United States; and

(iii) The trust is not subject to an automatic migration provision described in the regulations.

Treas. Reg. § 301.7701-7(c)(1).

g. For purposes of the safe harbor, the Treasury Regulations define "administration" as "the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions." Treas. Reg. § 301.7701-7(c)(3)(v). The preamble to the final regulations under IRC § 7701(a)(30)(E) note that an important factor in determining whether a trust passes the court test is where trustee meetings and activities take place. If those activities take place in the United States, even though the trustees are foreign, the trust could satisfy the court test because of its administration in the United States. T.D. 8813, 1999-9 I.R.B. 34, 36. The IRS made this point in response to a request from a commentator on the proposed regulations to make it clear that trustee activities and meetings in the United States *would not* cause the trust to meet the court test. *Au contraire*, the government said.

h. The safe harbor test, however, does not help a trust pass the court test when some of the trustees are non-U.S. persons or when some of the activities of the trust take place outside of the United States. As noted above, the IRS views the place in which trustees meet and in which trust activities take place as very important to the safe harbor test. A trust with foreign trustees or non-U.S. activities may not satisfy the safe harbor. Instead, the trust would otherwise have to prove that a U.S. court could exercise primary supervision over the administration of the trust.

(i) A trust without a connection to a UPC state cannot register the trust in a UPC state. The UPC trust registration provisions limit registration to trusts with their "principal place of administration" in the state. UPC § 7-101. According to § 7-101, the "principal place of administration" of a trust is "the trustee's usual place of business where the records pertaining to the trust are kept, or at the trustee's residence if he has no such place of

business." Thus, the ability to register a trust is of little assistance for a trust without a trustee that resides or conducts business in a UPC state.

(ii) State law may provide for jurisdiction over a trust without taking any of the affirmative steps suggested in Treas. Reg. § 301.7701-7(c)(4).

(a) Under New York law, for example, the Surrogate's Court has jurisdiction over a trust established by a settlor who was domiciled in New York when he or she established the trust. Under Surrogate's Court Procedure Act § 207, the Surrogate's Court of any county has jurisdiction over a lifetime trust the grantor of which was a New York domiciliary at the time proceedings are commenced.

(b) A trustee could also voluntarily submit himself or herself to jurisdiction in a U.S. state by filing a petition related to the trust in a U.S. state court. To the extent no one objects, then the court could issue an appropriate order. *See, e.g.*, *Rasmuson v. Walker Bank & Trust Co.*, 625 P.2d 1098 (Idaho 1981)(trustee defendants in a trust related case consented to court's personal jurisdiction so those defendants could not later raise lack of jurisdiction as a defense on appeal). *See generally, Bania v. Royal Lahaina Hotel*, 347 N.E.2d 106 (Ill. App. 1975) (describing Illinois law related to a nonresident's consent to personal jurisdiction).

3. Control Test

a. The second test a trust must meet to be a domestic trust is that one or more United States persons must have the authority to control all substantial decisions of the trust (the "control test"). IRC § 7701(a)(30)(E)(ii).

b. An individual is a "United States" person for control test purposes is either a U.S. citizen or a resident alien under either the green card test or the substantial presence test. *See* Treas. Reg. § 301.7701-7(d)(1)(referring to the definition of "U.S. person" in IRC § 7701(a)(30)). A domestic corporation can also be a U.S. person for control test purposes.

c. Treasury Regulation § 301.7701-7(d)(1)(ii) provides the following nonexclusive list of "substantial decisions" with respect to a trust:

(i) Whether and when to distribute income or principal;

(ii) The amount of any distributions;

(iii) The selection of a beneficiary;

(iv) Whether a receipt is allocable to income or principal;

(v) Whether to terminate the trust;

(vi) Whether to compromise, arbitrate, or abandon claims of the trust;

(vii) Whether to sue on behalf of the trust or to defend suits against the trust;

(viii) Whether to remove, add, or replace a trustee;

(ix) Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and

(x) Investment decisions; however, if a United States person under section 7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will.

d. Note that not all the "substantial decisions" may be made by fiduciaries, such as trustees. A trustee remover, for instance, may act in a nonfiduciary capacity. The fact that a person does not act in a fiduciary capacity, however, is not relevant for purposes of the control test. *See* Treas. Reg. § 301.7701-7(d)(1)(iii). Furthermore, the IRS considers powers to make substantial decisions held by grantors and beneficiaries when applying the control test. T.D. 8813, 1999-9 I.R.B. at 36. ("The final regulations . . . count all powers held by grantors and powers held by beneficiaries including those that affect solely the portion of the trust in which the beneficiary has an interest."). *See, e.g.,* PLR 200243031 (a revocable trust established under the laws of one of the U.S. states by a nonresident alien is a foreign trust because of the settlor's

power to revoke the trust, which was a "substantial decision" related to the trust).

e. Under the regulations, U.S. persons will control all substantial decisions if U.S. persons have "the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions." Treas. Reg. § 301.7701-7(d)(1)(iii). Thus, if a U.S. person and a non-U.S. person share authority to make a substantial decision and they must act jointly, then the non-U.S. person has the power to veto a substantial decision. This means that the non-U.S. person controls a substantial decision of the trust, which will cause the trust to flunk the control test.

f. According to the IRS, "control should be defined to mean full power over the trust consistent with a trustee's traditional role in trust administration." T.D. 8813, 1999-9 I.R.B. at 37. As a consequence of this principle, the IRS takes the position that a trust cannot avoid foreign status if a U.S. person who is not a trustee can veto a foreign trustee's decisions. *Id.* On the other hand, if a foreign person can veto the decisions of a U.S. trustee, the IRS will treat the trust as a foreign trust. *Id.*

g. By contrast, if a non-U.S. person controls a "ministerial" decision related to the trust, the trust will not flunk the control test, all other things being equal. According to the regulations, "ministerial decisions" include "decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions." Treas. Reg. § 301.7701-7(d)(1)(ii).

h. Note, however, that the safe harbor for the court test requires that the trust be administered exclusively in the U.S. Treas. Reg. § 301.7701-7(c)(1). The broad definition of administration in the court test regulations suggests that some ministerial decisions could fall within the category of "administration." Thus, if a foreign person makes these ministerial decisions for a trust, that trust would pass the control test but not qualify for the safe harbor under the court test. In this situation, the clients may need to make steps to otherwise qualify the trust under the court test.

4. Inadvertent Migrations

a. The government recognized that a domestic trust could inadvertently become foreign trust through changes in the identity of persons who make substantial decisions related to the trust. For instance, assume a trust designated a non-U.S. citizen residing in Canada as a successor trustee following the death or resignation of

the initial trustee. If the initial trustee was a U.S. citizen, his or her death or resignation would trigger the appointment of the Canadian resident as successor trustee. At that point the trust would "flunk" the control test because a Canadian resident would control substantial decisions of the trust. *See* IRC § 7701(a)(30)(E)(ii).

b. The Treasury Regulations provide that if the "death, incapacity, resignation, change in residency or other change with respect to a person that has a power to make a substantial decision of the trust" would cause the trust to flunk the control test and the change in personnel was not intended to cause the trust to migrate, the trust has 12 months from the change in personnel to "cure" the inadvertent migration. Treas. Reg. § 301.7701-7(d)(2)(i).

c. The trust can cure the inadvertent migration by either replacing the foreign person who caused the change in status. Alternatively, the foreign person can become a U.S. person in the 12-month cure period. Treas. Reg. § 301.7701-7(d)(2)(i). The regulations under IRC § 684 provide that if a trust takes advantage of the cure provisions following an inadvertent migration, the deemed disposition tax will not apply to the inadvertent migration. Treas. Reg. § 1.684-4(c).

d. A trust can request the district director to give it additional time to make the necessary modifications to cure the inadvertent migration. The trust must show reasonable cause for its failure to modify the trust within the 12-month period. The regulations suggest that reasonable cause would exist if the trust took reasonable actions to prevent the migration but could not complete the necessary actions due to "circumstances beyond the trust's control." Treas. Reg. § 301.7701-7(d)(2)(ii).

C. *Taxation of Distributions from Foreign Nongrantor Trusts*

1. A U.S. beneficiary must treat the receipt of any distribution from a foreign trust as a distribution from a nongrantor trust unless the beneficiary can establish that the distribution was from a grantor trust. *See* IRC § 6048(c)(2).

2. A distribution from a foreign nongrantor trust may or may not be taxable to the beneficiary. If the distribution would not carry out DNI to the beneficiary under general principles of IRC § 663(a)(1), then the beneficiary should not incur any taxable income as a result of receiving the distribution. If, however, the distribution does not qualify for the IRC § 663(a)(1) exception, the distribution may trigger income tax for the U.S. beneficiary.

3. If the distribution does not exceed the foreign trust's DNI for the year in question, computed according to the principles of IRC § 643, then the beneficiary will simply include the DNI deemed distributed to him or her on his or her U.S. individual income tax return.

   a. Unlike a domestic trust however, a foreign trust's DNI includes the trust's realized capital gains. IRC § 643(a)(6)(c). As a nonresident alien, a foreign nongrantor trust is not subject to U.S. income tax on its capital gains from the sale of U.S. assets, other than U.S. real property interests. The inclusion of the trust's realized capital gains in its DNI, however, will effectively make the trust's capital gains subject to U.S. income tax to the extent the trustee makes a distribution to a U.S. beneficiary.

   b. Again, these rules will not have any practical effect on a foreign trust with no U.S. source income or no U.S. taxable income because the trust is a nonresident alien. Rather, Congress placed the tax and the reporting burden on the U.S. beneficiary.

   c. Under a special rule, if the trust's fiduciary accounting income exceeds the trust's DNI and the trustee distributes an amount greater than its DNI but less than the trust's accounting income, the beneficiary can treat the excess as a nontaxable distribution. *See* IRC § 665(b); Treas. Reg. § 1.665(b)-1A(c)(2). Recall, however, that the definition of DNI of a foreign trust includes its realized capital gains, so under general fiduciary accounting principles it is unlikely that a distribution of accounting income will exceed a foreign trust's DNI for a year absent a lot of deductible expenses charged to principal.

   d. Under another special rule, a U.S. beneficiary's use of property of a foreign trust without the payment of the fair rental value of the property constitutes a distribution to the U.S. beneficiary from the foreign trust in an amount equal to the fair market value of the use of the property. *See* IRC § 643(i). Similarly, most loans from foreign trusts to U.S. beneficiaries result in a deemed distribution from the trust to the beneficiaries. *Id. See also* IRS Notice 97-34, 1997-1 C.B.422.

4. If the distribution from the foreign trust exceeds the trust's DNI or accounting income for the year of distribution, the distribution may be an "accumulation distribution" for U.S. income tax purposes, which triggers the "throwback tax." IRC § 665(b).

   a. Although Congress repealed the throwback tax on accumulation distributions from domestic trusts in 1997, the tax still applies to accumulation distributions to U.S. citizens and residents from

foreign nongrantor trusts. *See* IRC § 665(c). The purpose of the throwback tax as applied to distributions from foreign nongrantor trusts is to capture the U.S. tax that would have been paid had the trust distributed the accumulated DNI to the U.S. beneficiary on a current basis.

b. An accumulation distribution will occur if a trust has undistributed net income ("UNI"). If a foreign trust has DNI in a given year and the distributions, if any, from the trust do not fully carry out that DNI, the undistributed DNI becomes UNI. As noted above, a foreign trust's DNI includes its realized gains. As a result, a foreign trust that buys and sells investments could have substantial amounts of UNI, which means a later accumulation distribution could be quite large.

c. If a distribution is an accumulation distribution, the U.S. beneficiary must allocate or "throw back" the average amount of UNI for the preceding years in which the trust had UNI to three of the five preceding taxable years. The beneficiary must then compute the average increase in his or her taxes for those three years to which the average amount was thrown back. Finally, the beneficiary multiplies the average increase in tax by the number of preceding years in which the trust had UNI. The product is the throwback tax. Thus, under the accumulation distribution rules, the receipt of an accumulation distribution in effect triggers an income tax for previous years even though the beneficiary may never have received anything from the trust in those prior years.

d. Because the purpose of the throwback tax is to capture unpaid income tax on accumulated income that should have been distributed when it was earned income, the tax bears interest. *See generally* IRC § 668. Before January 1, 1996, the throwback tax bore simple interest at a rate of 6%. In 1996, however, Congress imposed an interest charge on the throwback tax based on the interest rate imposed on underpayments of federal income tax under IRC § 6621(a)(2), which is compounded daily. The law includes a complicated formula to determine the period for which interest is charged using the federal underpayment rate. IRC § 668(a).

e. Many features of the throwback tax enhance its onerous nature when applied to foreign nongrantor trusts.

   (i) The throwback tax is computed without regard to whether the UNI was capital gain or ordinary income, which effectively eliminates the benefit of the lower capital gains

tax rates for the U.S. beneficiary. *See* IRC § 667(b)(1)(D).

(ii) The throwback tax will apply without regard to how long the beneficiary has been a U.S. taxpayer. Thus, if a Canadian resident moves to the U.S. and obtains a green card, distributions from a foreign trust to the beneficiary will trigger a throwback to prior years in which the trust had UNI even if those years were before the beneficiary moved to the United States. In computing the throwback tax, however, the beneficiary's nonresident alien status will come in to play in the computation of taxes already paid on the UNI and will also affect the interest charge.

f. When a U.S. beneficiary receives a distribution from a foreign trust, the IRS presumes that the distribution is an accumulation distribution and, therefore, is subject to the throwback tax and interest. IRC § 6048(c)(2).

(i) The beneficiary can avoid accumulation distribution treatment by demonstrating to the IRS that the distribution was not an accumulation distribution.

(ii) If the trustee provides the beneficiary with a "Foreign Grantor Trust Beneficiary Statement" the beneficiary can treat the distribution as a gift for U.S. income tax purposes, which is not subject to income tax. IRS Notice 97-34, 1997-1 C.B. 422, § V(B).

(iii) If the beneficiary receives a "Foreign Nongrantor Trust Beneficiary Statement" that indicates the exact composition of the distribution, then the beneficiary need not rely on the default rule to compute the throwback tax on an accumulation distribution. IRS Notice 97-34, 1997-1 C.B. 422, § V(B). The statement, for instance, may indicate that the distribution did not exceed the trust's DNI or accounting income for the year in question. As noted above, the penalty tax does not apply to a distribution that does not exceed the greater of the trust's DNI or accounting income.

g. If the beneficiary did not receive a Foreign Grantor Trust Statement or a Foreign Nongrantor Trust Statement that indicates that the distribution was not an accumulation distribution, the beneficiary must determine how to compute the throwback tax. The beneficiary, however, may not receive sufficient information from the trustee of the foreign trust to make the computations

required under the accumulation distribution rules. In this situation, the government has established a "default" method of computing the throwback tax. The default method generally allocates a distribution in a given year to the current year and the three preceding years, taking prior distributions into account. *See* 2013 Instructions to IRS Form 3520 at 9.

h. The U.S. beneficiary will receive a credit for any foreign taxes or U.S. taxes paid on items deemed to be included in an accumulation distribution. *See* IRC §§ 665(a), 665(d). This is consistent with the purpose of the accumulation distribution rule to penalize the distribution of previously untaxed income. If the income in question has been subject to tax, whether foreign or U.S., it would not further the purpose of the accumulation distribution rule to apply the penalty tax to the distribution without taking account of those tax payments.

D. *Foreign Grantor Trust Issues*

1. A foreign trust that is a grantor trust as to a U.S. person must file an annual report of the trust's activities and operations for a calendar year with the IRS. IRC § 6048(b)(1)(A). Under IRC § 679 U.S. person is treated as the owner of a foreign trust's items of income, gain, and loss when he or she is the grantor of trust even if the trust would not otherwise be a grantor trust under the grantor trust rules. This is an antideferral regime similar to the CFC and PFIC regimes, and the legislation broadly defines the circumstances in which a trust is deemed to have a U.S. beneficiary in order to make the antideferral regime effective.

2. To comply with the annual reporting requirements, the trust must file an IRS Form 3520-A each calendar year and attach a "Foreign Grantor Trust Statement." The trustee must send a copy of the statement to the U.S. taxpayer owner of the trust and to each beneficiary who received a distribution from the trust in the year in question. The U.S. owner of the trust is responsible for "ensuring" that the trust files the Form 3520-A. IRS Notice 97-34, 1997-1 C.B. 422 § IV(A).

3. The deadline for filing Form 3520-A is the 15th day of the third month following the end of the trust's taxable year. This means that the Form 3520-A must be filed by March 15 of each year, rather than April 15. The trustee must on the same date furnish copies of the Foreign Grantor Trust Statement to the U.S. owner of the trust and the trust beneficiaries who received a distribution from the trust. The March 15 filing date is unfortunate because the logical filing date for a Form 3520-A is the 15th day of the fourth month following the end of the taxable year – April 15.

4. The government can impose a penalty for failing to file Form 3520-A of 5% of the gross value of the trust's assets. IRC § 6677(a).

5. The Instructions to IRS Form 3520 also direct a U.S. owner of the income, gain, and loss of a foreign grantor trust to file an IRS Form 3520 for each year in which the trust is a grantor trust.

   a. This filing requirement is in addition to the requirement that the trust file a Form 3520-A for each calendar year. Neither the Code nor Notice 97-34 contemplates this filing requirement, so the IRS appears to have developed this requirement on its own.

   b. The requirement that a U.S. owner of a foreign trust file an additional report recognizes the fact that the IRS may not be able to compel the trustee of a foreign trust to file an IRS Form 3520-A. By requiring that a person subject to U.S. jurisdiction file the report, the government is simply covering its bases.

   c. The U.S. taxpayer must file the Form 3520 at the same time he or she files his or her individual tax return. The taxpayer must file Form 3520 with the Ogden Service Center and not with his or her Form 1040.

E. *Compliance Issues for U.S. Beneficiaries of Foreign Trusts*

1. A beneficiary who receives a distribution from a foreign trust must report the receipt of the distribution to the IRS on Form 3520 in the year of distribution. IRC §§ 6048(c). There is no reporting threshold for distributions from foreign trusts. The beneficiary must file the Form 3520 at the same time he or she files his or her individual income tax return. The taxpayer files his or her Form 3520 with the IRS Ogden Service Center.

2. The reporting requirements apply equally to distributions from foreign grantor trusts and foreign nongrantor trusts. This is true even though a distribution from a grantor trust will be treated as a gift for U.S. income tax purposes and will not carry out DNI or UNI to the trust beneficiary from the foreign trust. IRS Notice 97-34, 1997-1 C.B. 422, § VI(A).

3. As discussed in detail above, a distribution from a foreign trust will be treated as an accumulation distribution unless the beneficiary can demonstrate otherwise.

   a. If the trustee provides the beneficiary with a "Foreign Grantor Trust Beneficiary Statement," the beneficiary can treat the distribution as a gift for U.S. income tax purposes, which is not subject to income tax.

b. If the beneficiary receives a "Foreign Nongrantor Trust Beneficiary Statement" that indicates the exact composition of the distribution, then the beneficiary need not rely on the default rule to compute the penalty tax on the accumulation distribution. The statement, for instance, may indicate that the distribution did not exceed the trust's DNI or accounting income for the year in question. As noted above, the penalty tax does not apply to a distribution that does not exceed the trust's DNI or accumulated income.

A BRIEF INTRODUCTION TO FATCA

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1. **Introduction**

(a) **What is FATCA?** Foreign Account Tax Compliance Act.

(i) Enacted as part of HIRE Act in 2010 – many changes to the Internal Revenue Code ("Code") dealing with identification and reporting of foreign accounts.

(ii) This outline deals primarily with the newly enacted Chapter 4 of the Code: *Taxes to Enforce Reporting on Certain Foreign Accounts*.

(1) Consists of four new sections: §§1471-1474.

(2) Purpose is to obtain information about U.S. taxpayers with unreported U.S. source income and encourage reporting of information by threat of withholding tax on payments to "recalcitrant" taxpayer and all those with financial relations to the taxpayer.

(b) **Withholding Tax**. Withholdable payments made to foreign financial institutions ("FFIs") or non-financial foreign entities ("NFFEs") are subject to a 30% withholding tax if the FFI or NFFE is not compliant with the FATCA rules (*i.e.*, in the case of an FFI, if it does not (i) register with the IRS, (ii) undertake certain due diligence, reporting and withholding requirements with respect to its U.S. account holders or (iii) certify to FFIs with which it holds accounts as to its FATCA status, or in the case of an NFFE, if it does not certify to FFIs with which it holds accounts as to its FATCA status and its U.S. owners).

(i) **What payments are withholdable payments?**

(1) **FDAP Income**. Payments of U.S. source fixed or determinable annual or periodic ("FDAP") income, including, rents, wages, interest and dividends; and

(2) **Proceeds from Sale of U.S. Property**. Payments of the gross proceeds from a sale or disposition of property that can generate U.S. source interest or dividends.

(ii) **Who is required to withhold?**

(1) **Withholding Agent**. Any person (including an FFI) with control or custody over any withholdable payments.

(2) **FFIs making foreign passthru payments**. If an FFI receives withholdable payments it is required to withhold on any further payment (a "passthru payment") made to (A) an account holder who does not comply with requests for information necessary to

determine if it is a U.S. account or (B) an FFI that has not complied with FATCA.

(c) **Why is this Important?**

(i) Initially some commentators believed that FATCA was only directed at foreign banks, brokers and other financial service providers who receive payments of U.S. source income and maintain accounts for other individuals or entities and not trusts. If this were the case, individuals with foreign trusts and entities would only be concerned about what information the foreign banks, etc. were disclosing to the U.S. or foreign governments, which would be out of those individuals' control.

(ii) However, notwithstanding the nomenclature ("accountholder," "financial entity," etc.), FATCA has a very broad scope and it applies to certain foreign trusts, holding companies (including certain disregarded entities)[1] and corporate trustees (including, seemingly, private trust companies).

(iii) Foreign trusts and other entities[2] may be obligated to report and that reporting may result in the disclosure of identifying information to the IRS, FFIs or foreign governments.

(iv) Individuals who are unaware of registration and reporting obligations of entities risk having payments received by those entities be subject to withholding, or be shut out from the global financial network as those FFIs who have complied with FATCA may refuse to hold accounts for or make payments to noncompliant or recalcitrant entities.

2. **Sources of Law - Regulations and IGAs.** Depending on a number of factors, the rules applicable to a foreign entity may either come from Treasury Regulations or one of two types of IGAs. Any obligation or rule under FATCA should be considered both under the Regulations and the IGAs.

(a) **Regulations**

(i) Chapter 4 of the Code provides minimal detail on how the law is applied. To interpret and provide further guidance, on January 18, 2013, Treasury released 544 pages of regulations (the "Regulations"), which were formally published in the Federal Register on January 28, 2013. In addition, new temporary regulations were released on February 21, 2014. The Regulations provide default rules for the application of FATCA in the case of entities that do not fall under the jurisdiction of an applicable IGA.

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1 Disregarded entities are in fact disregarded under the Regulations but are considered full-fledged entities under the IGAs.

2 Under FATCA, as in the Code generally, trusts are defined as entities and not fiduciary relationships. Pedants, take note.

(ii) The Regulations may provide guidance as to interpretation of the IGAs – definitions under the Regulations may be considered if they are not superseded by the IGA in question, and certain IGAs allow the country partner to the IGA (or FFIs subject to the IGA) to use definitions in the Regulations in lieu of a corresponding definition in the IGA.

(b) **Intergovernmental Agreements**.

(i) **Types of IGA.** Due to concerns that enforcement of FATCA in foreign countries may violate privacy or other laws in that country, the United States has offered foreign partner countries the opportunity to enter into one of two types of IGAs that supersede and alter the FATCA rules set out in the Regulations. Treasury has drafted "model" IGAs which contain standard terms under two separate models.

(1) **Model 1 IGAs**. Under a Model 1 IGA, the partner country to the IGA undertakes to adopt internal reporting rules that accomplish the same purposes as FATCA, and require FFIs subject to the IGA to report information about U.S. account holders to the partner country's tax authorities. The partner country also agrees to provide the reported information to the United States Treasury on an annual basis. The agreement may additionally be reciprocal whereby the U.S. agrees to provide similar information to the partner country.

(2) **Model 2 IGAs**. Under a Model 2 IGA, the partner country to the IGA undertakes to amend their laws in order to require FFIs subject to the IGA to report information about their U.S. account holders directly to the United States Treasury. Compliance under a Model 2 IGA is similar to compliance under the Regulations but has certain differences in scope and application.

(ii) **IGAs in Force**.

(1) 44 countries have signed IGAs as of October 27, 2014.

a. **Model 1 IGA Countries**. Australia, Belgium, Brazil, British Virgin Islands, Canada, Cayman Islands, Costa Rica, Czech Republic, Denmark, Estonia, Finland, France, Germany, Gibraltar, Guernsey, Hungary, Honduras, Ireland, Isle of Man, Israel, Italy, Jamaica, Jersey, Latvia, Liechtenstein, Luxembourg, Malta, Mauritius, Mexico, Netherlands, New Zealand, Norway, Poland, South Africa, Spain, Slovenia, Sweden, United Kingdom.

b. **Model 2 IGA Countries**: Austria, Bermuda, Chile, Japan, Switzerland.

(2) The following additional countries have reached agreements in substance and have agreed to be treated as having an IGA in force even though no formal agreement has been signed as of October:

a. **Model 1 IGA Countries**. Algeria, Anguilla, Antigua and Barbuda, Azerbaijan, Bahamas, Bahrain, Barbados, Belarus, Bulgaria, Cabo Verde, China, Colombia, Croatia, Curaçao, Cyprus, Dominica, Dominican Republic, Georgia, Greenland, Grenada, Guyana, Haiti, India, Indonesia, Kosovo, Kuwait, Malaysia, Montenegro, Panama, Peru, Portugal, Qatar, Romania, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Saudi Arabia, Serbia, Seychelles, Singapore, Slovak Republic, South Korea, Thailand, Turkey, Turkmenistan, Turks and Caicos Islands, Ukraine, United Arab Emirates, Uzbekistan

b. **Model 2 IGA Countries**. Armenia, Hong Kong, Iraq, Nicaragua, Moldova, Paraguay, San Marino, Taiwan

(3) For a list of jurisdictions treated as having an IGA in effect, go to: http://www.treasury.gov/resource-center/tax-policy/treaties/pages/fatca-archive.aspx.

(c) **Application of IGAs**

(i) **Enacting Legislation**. By entering into the IGA, the partner country commits to promulgating its own laws in line with the provisions of the IGA to enforce FATCA in that country. Some partner countries have not yet enacted enforcing legislation or guidance on how to interpret enforcing legislation, and there are many open questions as to how the IGAs will be interpreted under that country's laws.

(ii) **Entities Covered**. An IGA generally applies to an entity "*resident in*" or "*organized under the laws of*" the partner country.[3]

(iii) **Application of Multiple IGAs**. It is possible for an entity to be subject to more than one IGA (*e.g.*, an entity resident in the Bahamas, but organized under the laws of Bermuda). It is not clear whether such an entity must

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[3] It is unclear in some cases whether a trust is "organized under the laws of" a country solely because the laws of that country apply to the trust. Certain countries have therefore clarified when trusts are subject to their IGAs in their enacting legislation or guidance thereto. See, e.g., the Cayman Island guidance notes on implementing FATCA legislation: ("A trust is resident in the Cayman Islands, for the purpose of the [IGA], if it has a trustee that is a trust corporation which is incorporated, registered or licensed in the Cayman Islands.… Accordingly a trust which is established or governed under Cayman Islands law or administered in the Cayman Islands but has no Cayman Islands resident trustees does not fall within the scope of the [IGA].")

separately comply with each IGA. Implementing legislation in partner countries will hopefully provide guidance.[4]

3. **Classification of Foreign Entities as FFIs or NFFEs**

(a) **Foreign Financial Institution**.

(i) Generally, an FFI is required to take steps to comply with FATCA that an NFFE is not required to take (e.g., registering, reporting on an annual basis information about their U.S. account holders to the IRS or their local government).

(ii) **Under the Regulations**. A foreign entity can be classified under the regulations as a financial institution, and thus an FFI in the following ways:

(1) **Depository Institution**. An entity that accepts deposits in its ordinary course of a banking or similar business. A bank is a common example.

(2) **Custodial Institution**. An entity that holds financial assets for the benefit of one or more other persons.

(3) **Insurance Company**.

(4) **Holding Company or Treasury Center**. This includes holding companies or entities that hold currency or other assets as a hedging risk and are part of an affiliated group that contains another FFI, subject to limited exceptions.

(5) **Investment Entity**. The broadest classification of FFI. Any of the following will meet the definition of an Investment Entity.

a. An entity that conducts as a business one or more of the following for or on behalf of a customer:

i. Trading in money market instruments; foreign currency; foreign exchange, interest rate, and index instruments; transferable securities; or commodity futures;

ii. Individual or collective portfolio management; or

[4] See, *e.g,* , the U.K. guidance notes on the U.K. implementing FATCA legislation: ("If an entity is dual resident, such that it is resident in the UK and also in another country, it will still need to apply the UK legislation in respect of any Reportable Accounts maintained in the UK").

iii. Otherwise investing, administering, or managing funds, money, or financial assets[5] on behalf of other persons.

b. ***An entity with gross income primarily attributable to investing, reinvesting, or trading in financial assets and the entity is managed by another entity that is a bank, custodial institution, insurance company, or entity described in section 3(a)(ii)(5)(a) of this outline, above.***[6] An entity is managed by another entity if the managing entity performs, either directly or through another third-party service provider, any of the activities described in section 3(a)(ii)(5)(a) of this outline, above, on behalf of the managed entity.

c. An entity that functions or holds itself out as a collective investment vehicle, mutual funds, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.

(iii) **Under Model 1 and Model 2 IGAs**. FFIs are foreign entities that meet one of the following definitions:

(1) **Custodial Institution**. An entity that holds as a substantial part of its business, financial assets for the accounts of others.

(2) **Depository Institution.** A bank or other entity that accepts deposits in the ordinary course of business.

(3) **Specified Insurance Company**. An insurance company.

(4) **Investment Entity**. Any entity that conducts as a business (or is managed by an entity that conducts as a business)[7] one or more of the following activities or operations for or on behalf of a customer:

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[5] Financial assets are defined under Treas. Reg. § 1.1471-5(e)(4)(ii) as a security, partnership interest, commodity, notional principal contract, or any interest (including a futures or forward contract or option) in a security, partnership interest, commodity, notional principal contract, insurance contract, or annuity contract.

[6] While it is not entirely clear when an entity is "managed by" another entity for this purpose, foreign trusts with professional trustees or professional investment advisors (who are FFIs themselves) are generally considered to meet this definition.

[7] *Id.*

a. Trading in money market instruments; foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;

b. Individual or collective portfolio management; or

c. Otherwise investing, administering, or managing funds or money on behalf of other persons.

(b) **Non-Financial Foreign Entity**. An NFFE can generally be thought of as a foreign entity that does not meet the definition of an FFI. An NFFE does not need to register or otherwise take steps to comply with FATCA (other than certifying as to its FATCA status, generally on a Form W-8, and identifying certain of its U.S. owners).

4. **FFI Approaches to Compliance**

(a) **Generally.**

(i) **GIIN**. A Global Intermediary Identification Number ("GIIN"[8]) is the number that an FFI is expected to provide to a withholding agent to identify the FFI and its FATCA status. The GIIN consists of unique numbers assigned to the FFI as well as numbers indicating the type of FFI, the category of FFI and the country.[9] Depending on the method of compliance, the FFI can either obtain its own GIIN or use the GIIN of another entity that is acting in a sponsoring role.

(1) If an FFI is subject to more than one IGA, it is not clear whether they will obtain more than one GIIN. This may depend on whether they are "tax resident" in more than one country.

(ii) **W-8BEN-E**. Withholding agents will ask foreign entities, including FFIs, to provide a Form W-8BEN-E Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities), a Form W-8IMY Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting, or a substantially similar form, to certify the entity's status under FATCA. An FFI completing a W-8 will provide that FFI's identifying information including its GIIN.

(iii) **Expanded Affiliated Group**. An entity is generally a member of an Expanded Affiliated Group ("EAG") if it is affiliated to the other members

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[8] Pronounced, "gin," like the spirit.

[9] It is possible that an FFI without a GIIN may be ostracized and shut out of the global financial network. Some financial institutions have indicated they will avoid U.S. source income and only take clients with no U.S. ties – thus avoiding the threat of withholding taxes under FATCA, although that may be a more daunting task than initially thought.

through a common corporate parent. An entity is affiliated if the common parent or one or more members of the group own more than 50% of the vote and value of the stock of the entity, if a corporation, or more than 50% of the value of the beneficial interests in the entity, if a partnership or trust. The EAG will have a Lead FFI which is the FFI that carries out the FATCA registration for each of the members of its EAG. It seems that each EAG must have at least one Lead FFI, but could have multiple Lead FFIs.

(b) **Participating FFI / Reporting Model 1 FFI**.

(i) **General Description.** Under this mode of compliance, the FFI registers itself as an FFI in the manner indicated by the IRS. This can be thought of as the default method of FFI compliance under FATCA.

(ii) **Requirements**.

(1) **Regulations and Model 2 IGA**. Under the Regulations or a Model 2 IGA, an FFI can register with the IRS as a participating FFI and agree to enter into an FFI agreement with the IRS (agreeing to comply with applicable due diligence, reporting and withholding requirements).

(2) **Model 1 IGA.** Under a Model 1 IGA, an FFI can register with the IRS as a reporting Model 1 FFI and report to the applicable partner country's tax authorities information on U.S. account holders and payments made to non-compliant FFIs.

(iii) **Registration Deadline**

(1) **Regulations and Model 2 IGA**. After registering with the IRS, a participating FFI will be added to the IRS's FFI list. The IRS publishes the list online and updates it monthly by adding or removing FFIs as necessary. Withholding agents may reference the FFI list to determine whether or not to withhold on payments made to FFIs. The list is available at: http://www.irs.gov/Businesses/Corporations/FATCA-Foreign-Financial-Institution-List-Search-and-Download-Tool

(2) **Model 1 IGA**. Reporting Model 1 FFIs should register with the IRS by December 31, 2014.[10]

(iv) **Analysis Compared to other Compliance Approaches**

(1) **Pros**

[10] Reporting Model 1 FFIs should register earlier than December 31, 2014 to ensure that they are on the first IRS FFI List published after December 31, 2014.

a. **Clarity**. Generally well defined and clear process and applicability. Fewer open issues than other options.

b. **Does not indicate connection to other entities**. The FFI registers and reports on its own behalf so no connection to any other entity should be disclosed.[11]

(2) **Cons.** May be time consuming and burdensome for each FFI to register and separately comply with FATCA.

(c) **Sponsored Investment Entity**

(i) **Generally**. The FFI (which must be an investment entity) can be a sponsored investment entity if another entity, known as a sponsor, agrees to be responsible for the FFI's registration and reporting requirements.

(ii) **Requirements**.

(1) **Regulations.** To qualify as a sponsored investment entity, the following requirements must be met:

a. **Authorization**. The sponsor must be authorized the act on behalf of the sponsored investment entity to fulfill the requirements of an FFI agreement. This is clearly viable in cases where the sponsor is already authorized by law,[12] but, while not entirely clear, it appears that an investment entity can contractually provide a sponsor with this type of authority, even if there was no preexisting authority or relationship.

b. **Registration of Sponsor**. The sponsor must have registered with the IRS as a sponsor. This is separate and in addition to the sponsor's registration as an FFI, if applicable.

c. **Registration of Sponsored Investment Entity**. The sponsor must register the sponsored investment entity with the IRS by the later of January 1, 2016 or the date that the sponsored investment entity identifies itself as so qualifying.

d. **Sponsor Agreement**. The sponsor must agree with the sponsored investment entity to perform all due diligence,

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[11] One exception is that a Participating FFI/Reporting Model 1 FFI that is a Lead FFI in an expanded affiliated group ("EAG" – discussed above in section 4(c)) may need to disclose to the IRS some or all of the members of its EAG.

[12] *E.g.*, if the sponsor is already the fund manager, trustee, corporate director, or managing partner of the sponsored investment entity.

withholding, reporting, and other acts that the sponsored investment entity would be required to perform if it complied with FATCA as a participating FFI.

e. **Identification of Sponsored Investment Entity**. The sponsor must identify the sponsored investment entity in all reporting completed on the sponsored investment entity's behalf (if reporting is required because, for example, the sponsored investment entity has U.S. accounts); and

f. **No Previous Revocation**. The sponsor must not have had its status as a sponsor revoked by the IRS for materially failing to comply with the obligations described in the previous bullet points.

(2) **Model 1 and Model 2 IGAs**. The requirements under the IGAs are mostly the same as those under the Regulations. Note the following differences:

a. **Establishment Requirement**. It seems that the sponsored investment entity must be "established in" the partner country.[13]

b. **Sponsor's Authorization to Register with IRS**. Because an FFI subject to a Model 1 IGA is not otherwise required to enter into an FFI agreement, under a Model 1 IGA the sponsor must be authorized to fulfil applicable registration requirements on the IRS FATCA registration website.

c. **Initial Deadline for Registration**. See (iii) below.

(iii) **Initial Deadline for Registration.** In any case, the sponsoring entity will need to register itself by its own applicable registration date – the following dates apply to the sponsored entity.

(1) **Regulations and Model 2 IGA**. The sponsor will need to register the sponsored investment entity prior to December 31, 2015.

(2) **Model 1 IGA**. Registration of a sponsored investment entity is tied to whether it has U.S. reportable accounts (described below, in section 6).

a. If the sponsored investment entity has U.S. reportable accounts: it must register by the later of December 31, 2015 and 90 days after it first has U.S. reportable accounts.

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[13] See, however, 4(c)(iv)(2)b below.

b. If the sponsored investment entity has no U.S. reportable accounts it is not required to register.

(iv) **Analysis Compared to other Compliance Approaches**

(1) **Pros**

a. **Later Registration Date**. Because the registration date is significantly delayed when compared with participating FFI/ reporting model 1 FFI deadlines, it is a way to comply with existing FATCA rules while waiting for further guidance.

b. **Centralized**. If the client has multiple trusts, holding companies and related entities, the sponsored investment entity approach allows a single sponsor to perform all necessary tasks.

(2) **Cons**

a. **Identification of Connection Between Entities.** By using a common sponsor, multiple sponsored investment entities may reveal a link not only with the sponsor, but also among the various sponsored investment entities. This may trigger a privacy concern.

b. **Unresolved Issues**

i. The Model IGAs provide that this option is available to FFIs "established in" the jurisdiction partner to the IGA. It is unclear whether an FFI can comply with an IGA as a sponsored investment entity if it is not established in the partner jurisdiction.

ii. It is not entirely clear when a sponsor is authorized to act on behalf of an FFI.

(v) **Sponsored, Closely Held Investment Vehicle**. A distinct manner of compliance is to be a sponsored, closely held investment vehicle. While not entirely clear, sponsored, closely held investment vehicles should not have to register, regardless of whether they have U.S. accounts.

(1) **Requirements**. Under the regulations and the IGAs, to qualify as a sponsored, closely held investment entity, twenty or fewer individuals must own all of the debt and equity interests in the FFI (disregarding debt interests owned by participating FFIs and deemed-compliant FFIs, and equity interests owned by an entity if

that entity owns 100% of the equity interests in the FFI and is itself a sponsored, closely held investment vehicle).

(2) **Sponsor Requirements**. The sponsor of a sponsored, closely held investment vehicle must be either a participating FFI, reporting Model 1 FFI, or U.S. financial institution. Under the Temporary Regulations, the sponsor must be authorized to manage the FFI and enter into contracts on behalf of the FFI. Under the Model IGAs, the sponsor must be authorized to act on behalf of the FFI.

(3) **Registration Requirement**. While not entirely clear, it seems that a sponsored, closely held investment vehicle should not have to register (or be registered), even if it has U.S. accounts

a. **Regulations and Model 2 IGA**. A sponsored, closely held investment vehicle under the Regulations or a Model 2 IGA is a certified deemed-compliant FFI, and therefore is not required to register (or be registered).

b. **Model 1 IGA**. It is not clear whether a sponsored, closely held investment vehicle under a Model 1 IGA is a certified or registered deemed-compliant FFI. However, recent FAQs on the IRS website clarify that a sponsored closely held investment vehicle is treated as a certified deemed compliant FFI, and does not need to register unless it has a separate discrete requirement to do so (such as, it is acting as a lead FFI for entities in an EAG).

(4) **EAG Issue**. The Regulations seem to suggest that an FFI is not treated as a participating FFI or registered deemed-compliant FFI if any other FFI that is a member of its EAG is not also a participating FFI or registered deemed-compliant FFI.[14] What does this mean if a member of an EAG complies as a sponsored, closely held investment vehicle, which is a certified deemed-compliant FFI under the Regulations? Does it prevent the other FFIs in the EAG from qualifying as participating FFIs or registered deemed-compliant FFIs?

(d) **Trustee-Documented Trust**

(i) **Generally**. This method of compliance is only available for trusts subject to certain IGAs.[15] Similar to a sponsored investment entity method of

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[14] *See* Treas. Reg. § 1.1471(e)(1).

[15] Certain IGAs treat holding companies owned by trusts as trusts for this purpose, allowing the holding companies to comply as trusts.

compliance, another entity (in this case, the corporate trustee of the trust) takes responsibility for the FFI's reporting.

(ii) **Requirements**. A trust established under the laws of a country that is the counterparty to the IGA can be a trustee-documented trust if:

(1) The trust has a trustee that is a Participating FFI or a Reporting Model 1 FFI in any jurisdiction and

(2) The trustee reports the information required to be reported with respect to the trust's U.S. reportable accounts, if any.[16]

(iii) **Initial Deadline for Registration**.

(1) A trustee-documented trust should not have to register, even if it has U.S. reportable accounts.[17]

(iv) **Analysis Compared to Other Compliance Approaches**

(1) **Pros**

a. **No Registration**. This may be a way for a trust to avoid ever registering with the IRS.

b. **Consolidation of Reporting Duties**. A single trustee of multiple trusts can streamline and consolidate reporting duties.

(2) **Cons / Unresolved issues**

a. **Not available in all jurisdictions**. Not all partner country IGAs contain a trustee-documented trust option for compliance. In addition, the Model IGAs provide that this option is available to trusts "established under the laws of" the jurisdiction partner to the IGA. It is unclear whether a trust can comply with an IGA as a trustee-documented trust if it is not established under the laws of the partner jurisdiction.

b. **Lack of Clarity**. It is unclear whether a trustee-documented trust subject to a Model 1 IGA will have to register. Similarly, current guidance is silent as to whether a trustee-documented trust is required to provide

[16] *See* Rev. Proc. 2014-13: "…a participating FFI that is the trustee of a trustee-documented trust (as defined in an applicable Model 1 or Model 2 IGA) must report each U.S. account maintained by the trust as if the participating FFI maintained the account."

[17] A trustee-documented trust under an IGA is a certified deemed-compliant FFI, and therefore is not required to register.

withholding agents with its own GIIN (if it obtains a GIIN), the GIIN of its trustee or no GIIN at all.

5. **NFFE Approaches to Compliance**

(a) **No Registration**. An NFFE does not need to register or otherwise take steps to comply with FATCA. Upon opening a bank account or receiving a withholdable payment, an NFFE should be required to provide a *Form W-8BEN-E, Form W-8IMY* or substantially similar form, disclosing its identifying information, classification under FATCA and its U.S. owners to the withholding agent or FFI making the payment. An NFFE may need to provide an FFI or withholding agent with more information about its U.S. owners than an FFI would have to provide if it received the same payment.

(b) **Registration Option under the Regulations**. An NFFE can elect to register with the IRS and provide information about its U.S. owners to the IRS rather than to withholding agents or FFIs with which it holds financial accounts. It seems that such an NFFE will then be treated by a withholding agent in the same manner as an FFI. The NFFE will receive a GIIN to provide to withholding agents, but will not be required to enter into an FFI agreement.

6. **Reporting U.S. Accounts**

(a) **Generally**. An FFI has to report to the IRS or its country information about its *U.S. Accounts* under the Regulations or Model 2 IGA or its *U.S. Reportable Accounts* under a Model 1 IGA.

(b) **Regulations.** Under the regulations, a U.S. account is any financial account that is held by one or more specified U.S. persons or foreign entities that have one or more substantial U.S. owners (a “U.S. owned foreign entity”).

(i) **Financial account**. In the case of an investment entity, a financial account includes an equity or debt interest in the entity.

(ii) **Trusts**. Any of the following persons would be deemed to hold an equity interest in a trust:

(1) A person deemed to “own” all or part of the trust under the U.S. grantor trust rules;

(2) A beneficiary who is entitled to a mandatory distribution from the trust; and

(3) A beneficiary who may receive a discretionary distribution from the trust but only if such person receives a distribution in a given calendar year.

(iii) **Substantial U.S. Owners**.

(1) **Corporation**. In the case of a foreign corporation, a substantial U.S. owner is any specified U.S. person who owns, directly or indirectly, more than 10% of the stock in the corporation (by vote or value). Stock of a foreign corporation that is owned by a trust (other than a trust that is a participating FFI or a deemed-compliant FFI) is considered as being owned by the trust's beneficiaries holding more than 10% of the beneficial interests of the trust.

(2) **Trusts**. In the case of a foreign trust, a substantial U.S. owner is any specified U.S. person who holds, directly or indirectly, more than 10% of the beneficial interests of the trust. A person holds a beneficial interest in a foreign trust if he or she has the right to receive a mandatory distribution or may receive a discretionary distribution. However, to determine if a discretionary beneficiary has met the 10% threshold for an applicable period, only the value of the property actually distributed is taken into account.

a. **De Minimis Exemption**. A U.S. person is not treated as a substantial U.S. owner if the fair market value of the property distributed from the trust to such person is $5,000 or less.

(3) **Special Rule for Investment Entities**. In the case of an investment entity, a substantial U.S. owner is any specified U.S. person who holds, directly or indirectly, more than 0% of the beneficial interests (*i.e.*, ANY interest), taking into account any applicable de minimis exception.

(4) **Related Persons.** To determine whether a person has a more than 10% (or 0%, as applicable) interest in a foreign entity, ownership interests of related persons are attributed to that person. For this purpose, a related person is defined broadly to include any spouse, sibling, parent, grandparent, child or grandchild, whether the related person is U.S. or foreign.

(iv) **Reporting.** It seems that an FFI with a financial account held/maintained by a non-U.S. entity with substantial U.S. owners does not have to report the account to the IRS if the non-U.S. entity is an FFI.

(c) **Model 1 IGA**.

(i) **U.S. Reportable Account**. Under a Model 1 IGA, a Reportable U.S. Account is any financial account held by one or more specified U.S. persons or a non-U.S. entity with one or more controlling persons who is a specified U.S. person.

(1) **Exception under Annex I**.

a. An account is not treated as a U.S. Reportable Account if it is not identified as a U.S. Reportable Account after application of the due diligence procedures in Annex I of the Model 1 IGA.

b. E.g., An account held by a non-U.S. entity that is an FFI is not a U.S. Reportable Account (even if the entity has U.S. controlling persons), but if the entity is treated as a nonparticipating FFI by the IRS, payments made to the entity may have to be reported.

(ii) **Financial Account**. Under the Model 1 IGA, a financial account is an account maintained by an FFI, and includes an equity or debt interest in an Investment Entity.

(iii) **Equity Interest.** In the case of a trust that is an FFI, any person treated as a settlor or beneficiary of all or a portion of the trust, or any other natural person exercising ultimate effective control over the trust, holds an equity interest. A specified U.S. person is treated as being a beneficiary of a foreign trust if he/she has the right to receive a mandatory distribution or may receive a discretionary distribution from the trust.

(iv) **Controlling Person**. A controlling person is any natural person who exercise control over an entity. In the case of a trust, this means the settlor, trustees, the protector (if any), the beneficiaries or a class of beneficiaries, and any other natural person exercising ultimate effective control over the trust.

(1) It is not clear whether the settlor, trustees, protector and beneficiaries of a trust are always controlling persons with respect to the trust or are only controlling persons if they exercise ultimate effective control over the trust.

(d) **Model 2 IGA**

(i) **U.S. Account**: Under a Model 2 IGA, a U.S. Account is any financial account held by one or more specified U.S. persons or by a non-U.S. entity that has one or more controlling persons that is a specified U.S. person.

(1) **Exception under Annex I**.

a. An account is not treated as a U.S. Account if it is not identified as a U.S. Account after application of the due diligence procedures in Annex I.

b. E.g., An account held by a non-U.S. entity that is an FFI is not a U.S. Account (even if the entity has U.S. controlling

persons) but if the entity is treated as a nonparticipating FFI by the IRS, payments made to the entity may have to be reported.

(ii) **Financial account**. The Model 2 IGA directly references the definition under the Regulations. See section 6(b) of this outline.

(iii) **Controlling Person**. A controlling person is any natural person who exercises control over an entity. In the case of a trust, this means the settlor, trustees, the protector (if any), the beneficiaries or a class of beneficiaries, and any other natural person exercising ultimate effective control over the trust.

(e) **Common Examples**

(i) **Foreign Trust with discretionary U.S. beneficiaries:**

(1) **Regulations/Model 2 IGA**. If the Trust is an FFI subject to the Regulations or a Model 2 IGA, it should not have U.S. accounts unless and until a U.S. beneficiary receives a distribution.

(2) **Model 1 IGA**. If the Trust is an FFI subject to a Model 1 IGA, it should have U.S. accounts if it has discretionary U.S. beneficiaries, unless under the terms of the IGA, the FFI can apply the definition of "Equity Interest" in the Regulations.

(ii) **Foreign holding company, held directly by a foreign trust with discretionary U.S. beneficiaries**

(1) **Regulations**. If the holding company is an FFI subject to the Regulations, it should not have a U.S. account unless and until a U.S. beneficiary (or a related person) receives a distribution from the trust. Even then, it seems that the holding company should not have to report to the IRS information about the U.S. beneficiaries of the trust if the trust is an FFI.

(2) **Model 1 IGA**. If the holding company is an FFI subject to a Model 1 IGA, it should not have U.S. accounts provided that the foreign trust that holds an interest in the holding company is an FFI. If the trust does not comply with FATCA as a participating FFI or a deemed-compliant FFI, the holding company may be required to report information on the trust.

CONTINUING EDUCATION
OF THE BAR

DISCLOSURE, STATUTE OF LIMITATIONS AND PENALTIES

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I. BENEFITS OF DISCLOSURE

A. Less chance of audit.

B. Ability to present taxpayer's position

C. Starts the running of the statute of limitations.

D. May be a penalty defense.

E. Might limit possibility of preparer penalty.

II. WHAT DISCLOSURE IS REQUIRED.

A. Generally, a detailed list of the assets transferred needs to be disclosed. Reg. 25.6019-4.

B. If there are going to be discounts for lack of marketability, minority interest, partial interest, blockage, etc., an explanation should be contained on the return or on an attachment.

C. For stock of a closely-held corporation, financial statements and balance sheets are desirable.

D. For real estate, a detailed description is appropriate.

E. For safety there should be a detailed appraisal if the asset is significant.

F. Information relating to foreign accounts.

III. DISCLOSURE AND STATUTE OF LIMITATIONS.

A. If a gift is not shown on a return or in a statement attached to the return in a manner adequate to apprise the IRS of the nature of such item, there is no statute of limitations. IRC §6501(c)(9). Reg. 301.6501(c)-1(f) describes what is necessary for adequate disclosure. The Regulation is satisfied if there is a qualified appraisal prepared by a qualified appraiser. Completed transfers to members of the family made in the ordinary course of business may be adequately disclosed if properly reported for income tax purposes. Reg. 301.6501(c)-1(F)(4). Transfers reported as incomplete gifts will not start accrual of the statute of limitations. Reg. 301.6501(c)-1(F)(5).

B. The general rule is that the statute of limitations expires three years after the later of the due date of the return or the date of actual filing.

C. If the total gross estate is understated by at least 25%, the statute of limitations is extended to six years.

D. For items not adequately disclosed or for returns not filed, there is no statute of limitations.

E. A request for prompt assessment may be made under IRC §6501(d). The gift tax statute of limitations expires eighteen months after written request is made by a decedent's representative.

F. Gift tax issues can arise during the audit of a surviving spouse which may be many years after the date of the gift. If the statute of limitations is open, the recipient of the gift may also be liable even if not knowing that the gift was made. IRC §6324, 6901.

G. In a Chief Counsel Memorandum attached to this outline, failure to comply with foreign account disclosure requirements on an income or estate tax tolls the statute limitations with respect to the entire return. There is a partial defense of reasonable cause and not willful neglect which will limit the tolling to the omitted items.

IV. PENALTIES

A. Late Filing and Late Payment.

i. Failure to file 5% per month up to 25%. If fraudulent failure to file penalty is 15% per month up to a maximum of 75%. Defense can be reasonable cause and not due to willful neglect.

ii. Failure to pay penalty is 1/2% per month, increasing to 1% per month if not paid within 21 days after notice and demand, up to a maximum of 25%. Imposition of failure to pay penalty can reduce failure to file penalty by up to 2.5%.

B. Accuracy-Related Penalties.

i. Negligence.

ii. Undervaluation: Penalty may be up to 20% if value ultimately determined to be over 150% of the amount shown on the return and may be up to 40% if value ultimately determined is more than double the amount shown on the return.

C. General defenses under IRC §6664(c).

i. Reasonable cause and taxpayer acted in good faith.

ii. Definition of reasonable belief – IRC §6501(d)(4) relates to reasonable belief in the context of reportable transaction understatements. As a practical matter, its application might be much broader. Reasonable belief

requires facts and law that exist at the time the return was filed and relates solely to the taxpayer's chances of success on the merits.

iii. Reliance on professionals. In addition to the case law, IRC §6501(d)(4) relating to reportable transactions does not allow reliance on an opinion given by certain professionals or by certain opinions that are "disqualified." A disqualified tax advisor is any one of the following:

(1) A material advisor who participates in the organization, management, promotion or sale of the transaction or is related to any person who participates.

(2) Compensated directly or indirectly by a material advisor.

(3) Has a fee arrangement which is contingent on the tax benefits to be obtained and

(4) Is determined to have the disqualifying financial interest as set forth in Regulations.

iv. A disqualified opinion is one that is

(1) Based on unreasonable facts or legal assumptions.

(2) Unreasonably relies on representations, statements, findings or agreements of the taxpayer.

(3) Does not identify and consider all relevant facts or

(4) Fails to meet any other requirement as the Regulations may prescribe.

D. Reliance on Professional.

i. In the non-tax shelter area, reasonable cause based on advice of a professional requires that the professional was competent, received necessary and accurate information, and the taxpayer relied in good faith. Some cases dealing with the issue are:

ii. Neonatology Associates, 115 T.C. 43(2000). In this case, the advisor was an insurance salesman. The court set forth three standards that are necessary to support a reliance on tax professional defense:

(1) The advisor was a competent professional who had sufficient expertise to justify reliance.

(2) The taxpayer provided necessary and accurate information to the advisor

(3) The taxpayer actually relied in good faith on the advisor's judgment. See Estate of Shirley C. Giovacchini, T.C. Memo 2013-27 (2013) holding that the Neonatology Elements, affm'd 299 F.3d 221 (3d. Cir. 2002) were satisfied, including the application of an undervaluation penalty. The standard for reliance has been set forth by the United States Supreme Court in United States v. Boyle, 469 U.S. 241, 251 (1985)

> "When an accountant or attorney advises a taxpayer on a matter of tax law such as whether reliability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advise for an accountant or an attorney to require the taxpayer to challenge the attorney, to seek a 'second opinion' or to try to monitor counsel on the provisions of the code himself but nullify the various purpose of seeking the advice of a presumed expert in the first place."

See also Henry v. Commissioner, 170 F.3d 1217(9th Cir. 1999).

Cases have also upheld reliance on appraisers for purposes of preventing the application of the undervaluation penalty. Estate of Jung v. Commissioner. 101 T.C. 412 (1993); Estate of Giustina v. Commissioner, T.C. Memo 2011-141.

E. Novel Issues. The accuracy-related penalty is inappropriate where an issue to be resolved by the court is one of first impression involving unclear statutory language. Buney v. Commissioner, 114 T.C. 259 citing Everson v. United States, 108 F. 3d 234 (9th Cir. 1997)

> "Specific question raised by this appeal (whether trees planted to prevent soil erosion on a commercial farm are depreciable) is one of first impression and was clearly subject to reasonable debate. The Commissioner should not have imposed negligence penalties on the Everson.") and

Lemishow v. Commissioner, 110 T.C. 110 (1998)

> "Since this is the first time we have considered the rollover requirements as to the specific character of the property to be transferred, we find for Petitioner as to the negligence penalty."

Gee v. Commissioner, 127 T.C. 1 (2006); Hitchins v. Commissioner, 103 T.C. 711.

F. Possible waiver of attorney-client privileged where taxpayer raises a good faith defense. The assertion of a good faith defense subjects the taxpayer to the risk of losing the attorney-client and tax professional privilege. In A.D. Investment 2000 Fund, LLC v. Commissioner, 142 T.C. 248 (2014), the court held that an assertion of a good faith defense to the imposition of an accuracy-related penalty waived the attorney-client privilege. In this case, the taxpayers did not assert any advice of counsel defense in order to avoid the holding in Johnston v. Commissioner, 119 T.C. 27 where the court held that the assertion of the defense waives the attorney-client privilege. The court basically said that by inserting subjective intent as an element of a defense, the party waives the protection of the attorney-client privilege.

> "Petitioners averments in support of their affirmative defenses to Respondents determination of accuracy-related penalties put into contention the state of mind of those who acted for the partnerships and the partnerships good-faith efforts to comply with the tax law. If Petitioners persist in those defenses, it would be unfair to deprive Respondent of knowledge of the contents of the opinions and the opportunity to put those opinions into evidence. If Petitioners persist, they sacrifice the privilege to withhold the contents of the opinions."

V. PREPARER PENALTIES

A. This can adversely impact the tax professional. In addition to the statutory penalties, imposition of a preparer penalty may cause referral to the IRS Office of Professional Responsibility and to the State agency that regulates the professional.

B. The penalty is based on preparation of a return or claim for refund based on an unreasonable position in which the preparer knew or reasonably should have known of the position. The penalty is the greater of $1,000 or 50% of the income derived or to be derived with respect to the return or claim. Unreasonable positions include:

i. If a tax shelter or reportable transaction, a position is unreasonable unless it is reasonable to believe that the position would more likely than not be sustained on its merits.

ii. If a position was disclosed and is not involved in any tax shelter or reportable transaction, a position is unreasonable unless there is a reasonable basis for the position.

iii. For non-disclosed positions that are not tax shelters or reportable transactions, there must be substantial authority for the position.

iv. No penalty shall be imposed if there is a reasonable cause for the understatement and the tax return preparer acted in good faith.

C. Willful or Reckless Conduct. If the understatement is due to willful or reckless conduct, the minimum amount of the penalty increases to $5,000. Willful or reckless conduct includes a willful attempt to understate the liability for tax or reckless or intentional disregard of rules or regulations.

D. Procedure to Challenge.

i. If the preparer pays 15% of the penalty within 30 days after notice and demand and files a claim for refund within that time, collection is stayed until final resolution of the proceedings relating to the correctness of the penalty imposition. The stay of collection will end 30 days after denial of the claim or, if earlier, within 6 months and 30 days after the refund claim was filed unless an action is brought in the United States District Court for the determination of the liability.

ii. The penalty is abated if the taxpayer's liability was not understated.

E. Some Tactical Considerations.

i. Statute of limitations for preparer penalty is 3 years after the later of the due date of the return or the date the return was filed.

ii. If liability of taxpayer has not been resolved, typical reaction of preparer is to extend the statute of limitations. This allows the taxpayer's case to proceed to finalization before it is necessary to resolve the preparer penalty.

iii. If preparer does not waive the statute of limitations, the Service must either (i) issue notice and demand for the penalty or (ii) allow the statute of limitations to lapse, thereby eliminating preparer liability.

iv. This could give the taxpayer two chances to litigate the tax liability. If the preparer establishes that no tax was owing, this may be collateral estoppel against the Government. If the preparer loses, the taxpayer was not a party and still has the right to proceed with any action to contest the tax.