Probate and Trust Law Section Newsletter

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Report of the Chair

By JULIA B. FISHER

Greetings to all! I look forward to working this year with three wonderful officers – Mary Jane Barrett (Chair Elect), Kathleen Stephenson (Vice Chair) and Kevin Gilboy (Secretary) – and an energetic and creative Executive Committee. Kathleen is already in the process of planning an outstanding Annual Meeting so save the date – November 29, 2005.

We have all noticed that the ways in which the Section communicates with its members – and that members of the Section communicate with one another – have changed significantly in the past few years. For example, our Newsletter is now "delivered" electronically. The Section's e-mail listserv is a quick and efficient way to reach many members of the Section to announce CLE events, disseminate substantive and procedural questions from members, and announce significant court decisions or legislation. If you are not already registered for the listserv, you can do so via the website of the Philadelphia Bar Association at www.philabar.org. We will work hard this year to coordinate and leverage the valuable work of the Section's committees, and our individual members, and to keep the flow of information vital and useful.

Every year the work of the Section is largely carried out by the Section's committees and this year will be no exception.

1. The Rules and Practice Committee, chaired by Margie Thompson, will continue to work with Judge O'Keefe and others in the Philadelphia court system to roll-out e-filing in the Orphans' Court. The Committee has worked hard for the past few years on the Red, Green and Blue Books, all of which will soon be accessible through the Section's website.

2. The Legislative Committee, chaired by Rob Friedman, is working on proposed legislation to clarify disclaimers of jointly held property. As other legislative initiatives arise during the year, the Committee will weigh in.

3. The Education Committee, co-chaired this year by Karen Stockmal and Judy Stein, will continue to plan and present our CLE programs with PBI. Upcoming meetings: on June 7 the topic is "Life After Death (Tax): Wealth Planning Practice Regardless of Estate Taxes" and

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Report from the Legislative Committee: Recent Statutory Changes

By THOMAS O. HISCOTT
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Act No. 175 (Senate Bill #95), which was enacted in November 2004 at the very end of the 2003 - 2004 session of the General Assembly, primarily contains amendments to Title 23 [Domestic Relations]. However, it includes several provisions important to estate planning attorneys.

First, Act 175 adds new §3106 to Title 23. Section 3106, titled "Premarital Agreements", provides that a premarital agreement shall not be enforceable if the party seeking to set aside the agreement proves, by clear and convincing evidence, that (1) the party did not execute the agreement voluntarily; or (2) the party, before execution of the agreement, (i) was not provided a fair and reasonable disclosure of the property or financial obligations of the other party, (ii) did not voluntarily and expressly waive, in writing, any right to such disclosure beyond the disclosure provided, and (iii) did not have an adequate knowledge of the property or financial obligations of the other party.

Section 3106 sets a high hurdle for a party seeking to void a prenuptial agreement. Section 3106 also makes it clear that full disclosure of the assets of the parties is not required for a prenuptial agreement to be valid (because the statute allows disclosure to be waived), although a prudent practitioner would certainly provide full disclosure, have the other party approve the adequacy of such disclosure, and waive the right to additional disclosure.

The controversial provision included in prior drafts of Act 175 that stated a prenuptial agreement was void if executed within 60 days of the marriage was not included in the final version of Act 175. Nevertheless, there will undoubtedly be a case in which a party seeking to set aside a prenuptial agreement argues that because the agreement was executed only a day or two before marriage, the party did not execute the agreement voluntarily, and therefore the agreement is void.

Act 175 does not address post-nuptial agreements.

The addition of §3106 was effective 60 days after enactment, which was January 28, 2005.

The genesis of §3106 was the April 1999 Report of the Advisory Committee on Domestic Relations Law of the Joint State Government Commission. That report includes a comment as follows: "It is important to note that this section [§3106] does not apply in the context of the death of either party. This Section only applies to agreements regarding matters within the jurisdiction of the court under the Divorce Code." Courts may interpret official comments of the Advisory Committee in determining the intent of the General Assembly. *See* 1 Pa. C.S. §1939 and *In Re Martin's Estate*, 365 Pa. 280, 74 A.2d 120 (1950). This comment raises the spectre that a prenuptial agreement could be subject to one standard for purposes of divorce (§3106) and another standard for purposes of death. Section 3106 does not represent a significant departure from the standard set forth in *Simeone v. Simeone*, 525 Pa. 392, 581A §162 (1990), and therefore this may be an academic issue. Nevertheless, this comment suggests that estate planning practitioners should continue to prepare prenuptial agreements carefully, provide full disclosure, and not rely on §3106 if the ability to enforce the agreement after death is important.

Act 175 also added 20 Pa.C.S. §3323(d.1), which provides that if one party dies during the course of divorce proceedings, if no decree of divorce has been entered, and if grounds for divorce have been established, that the economic rights and obligations of the parties arising under the marriage shall be determined pursuant to Title 23 and not pursuant to Title 20. Grounds for divorce are established (i) if both parties have filed affidavits of consent; (ii) if one party has filed an affidavit and the other party has not filed a counter-affidavit or the counter-affidavit denies the averments of the first party's affidavit, and the court determines that the marriage is irretrievably broken and the parties have lived separate and apart for at least two

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What Every Estates Practitioner Should Know about the Pennsylvania Realty Transfer Tax

By MATTHEW L. ROSIN
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This article highlights those aspects of the Pennsylvania realty transfer tax that are of greatest significance to estates practitioners.[2] Many of the realty transfer tax exclusions that are of particular interest to estates practitioners are discussed later in this article. We will begin, however, with the most fundamental question of all: What is the realty transfer tax?

When Does the Tax Apply?

In general, the realty transfer tax is a tax on the value of an interest in real property transferred by a "document," whether or not the document is recorded. *See* §8102-C.[3] A "document" includes a deed, but excludes the following: (1) a will; (2) a mortgage, deed of trust or other instrument of like character given as security for a debt, or a deed to release such debt; (3) a land contract (*i.e.*, an agreement of sale) where legal title passes only upon payment of the total consideration specified in the contract, if the consideration is payable over a period of 30 years or less; and (4) an instrument that solely grants, vests or confirms a public utility easement. §8101-C. A lease is not subject to realty transfer tax unless it is a perpetual leasehold, for a term of at least 30 years or the lessee has an "equity" interest in the real estate. *Id.* ("title to real estate").

It is not surprising that a transfer by deed of an interest in real property, such as a life estate, is subject to realty transfer tax. It may come as a surprise, however, that a transfer of an interest in a family limited partnership or other entity may result in realty transfer tax. The tax applies when there is an acquisition of a "real estate company." §§8102-C; 8101-C (last sentence in the definition of document); 8102-C.5(a), (c). A "real estate company" is a corporation or association that satisfies three tests.[4] First, at least 90% of the ownership interests in the entity must be held by 35 or fewer persons.[5] Second, the entity must be primarily engaged in the business of holding, selling or leasing real estate in Pennsylvania. Third, the entity must meet either a gross receipts or a value test. The gross receipts test is met if the entity derives at least 60% of its annual gross receipts from the ownership or disposition of Pennsylvania real estate.[6] The value test is met if the current monetary worth of the entity's Pennsylvania real estate is at least 90% of the current monetary worth of the entity's entire tangible asset holdings (exclusive of tangible assets that are freely transferable and actively traded on an established market).[7]

Once it has been determined that an entity is a real estate company, the next step is to determine whether the entity is an acquired real estate company. A real estate company becomes an acquired real estate company upon a change in the ownership of the entity (such as by the sale, gift, or bequest of an ownership interest, the addition or withdrawal of a new member or the issuance or cancellation of stock) if such change (1) does not affect the continuity of the entity and (2) together with prior changes (if any) within the preceding 3 years, has the effect of directly or indirectly transferring at least 90% of the total ownership interest in the entity.[8] Within 30 days after becoming an acquired real estate company, the company must present a "decla-

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years at the time of the filing of the affidavit; or (iii) if the court adopts a report of the master or makes its own findings that grounds for divorce exist. *See* 23 Pa. C.S. §3301.

A corresponding change to 20 Pa. C.S. §2203(A) [Right of Election] provides that in this situation, *i.e.,* when one party to a marriage dies during the pendancy of a divorce action, after grounds for divorce have been established, that the surviving spouse will have no right to an elective share of the first spouse's estate.

These changes are effective as of January 28, 2005, but apply to divorces commenced before the effective date.

ration of acquisition" to the recorder of each county in which the entity holds real estate and pay the realty transfer tax.[9]

The realty transfer tax exclusions that apply to transfers of real estate are inapplicable to transfers of ownership interests in real estate companies. However, transfers between members of the same family[10] of an ownership interest in a real estate company are excluded. §8102-C.3(20). All other transfers of an ownership interest in a real estate company are taken into account in determining whether the entity has become an acquired real estate company. For example, if 90% or more in a real estate company is transferred to a charitable or other nonprofit organization – even to one of the few types of organizations to which a transfer of real estate would be excluded under §8101-C.3(14), (17) or (18) – the entity becomes an acquired real estate company and owes realty transfer tax if the transfer does not affect the continuity of the entity. Similarly, if a decedent bequeaths 90% or more of the total ownership interest in a real estate company to a person who is not a member of the same family, the entity becomes an acquired real estate company and owes realty transfer tax if the bequest does not affect the continuity of the entity.

The transfer tax of real estate between a corporation or association and its shareholders, partners or members falls within the general rule subjecting transfers of interests in real property to the realty transfer tax. 61 Pa. Code §91.154. For example, the transfer of real estate into a family limited partnership and the transfer of real estate out of that partnership to a partner are both taxable transfers unless an exclusion applies. An exclusion exists for transfers of real estate out of an entity if (1) the real estate was held of record in the name of the entity; (2) the grantee owns an interest in the entity in the same proportion as his or her interest in or ownership of the real estate being conveyed; and (3) the grantee has held the ownership interest in the entity for more than two years.[11]

Who Bears Liability for the Tax?

In general, the grantor and the grantee are jointly and severally liable for the tax. 61 Pa. Code §91.111(b). Although the parties may agree to allocate liability among themselves in any manner they desire, the Department of Revenue may pursue any of the parties for the full amount of the tax. Id. However, because the United States, the Commonwealth of Pennsylvania and their instrumentalities, agencies and subdivisions are exempt from the realty transfer tax, the other parties to the transaction bear liability for the entire tax due. §8102-C.2; 61 Pa. Code §91.192. In the case of an acquired real estate company, the company itself is subject to the realty transfer tax.

Rate of Tax

The Pennsylvania realty transfer tax rate is currently 1% of the consideration in the case of a bona fide sale at arm's length for actual monetary worth. §§8102-C; 8101-C (paragraph 1 of the definition of value). In the case of a gift or other transaction for consideration less than the actual monetary worth, the tax rate is 1% of the property's actual monetary worth computed by multiplying the property's assessed value by the common level ratio factor. §8101-C (paragraph 2 of the definition of value). The Philadelphia realty transfer tax rate is currently 3%, making the combined state and local rate 4%. Philadelphia Code §19-1403(1)(g).

Exclusions

There are numerous exclusions from the Pennsylvania realty transfer tax. *See* §8102-C.3. Many of the exclusions should be of keen interest to estates practitioners, including the following exclusions discussed below: (1) transfers between certain family members; (2) property passing by testate or intestate succession; (3) certain transfers to and from "living trusts" and "ordinary trusts"; (4) transfers from trustee to successor trustee; (5) transfers to certain charitable and other nonprofit organizations; and (6) certain partitions. Certain other exclusions are also highlighted below.

Transfers Between Certain Family Members

The family exclusion applies to transfers of real estate between the following persons:

- Husband and wife;
- Persons who were previously husband and wife, provided the property was acquired by either or both of them before the granting of the final divorce decree;
- Parent and child or the spouse of such child;
- Grandparent and grandchild or the spouse of such grandchild;[12] and
- Brother or sister (or spouse of a brother or sister) and brother or sister (or the spouse of a brother or sister).[13]

The regulations provide that the term "spouse" includes the spouse of a deceased person un-

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less the spouse has remarried. 61 Pa. Code §91.193(b)(6)(i)(D), (E). For the parent/child and grandparent/grandchild exclusion to apply, the relationship may be established by adoption, but a step-person relationship is insufficient. 1 Pa. C.S. §1991 (child includes child by adoption); *Steidle v. Commissioner*, 717 A.2d 1084 (Pa. Commw. Ct. 1998) (transfer to stepchild not excluded). Siblings need share only one parent in common for the exclusion to apply. *See* 61 Pa. Code §91.193(b)(6)(i)(C). The Philadelphia Code excludes a transfer between "life partners," Philadelphia Code §§19-1405(6); 9-1106(2), but the Pennsylvania Supreme Court affirmed the Commonwealth Court's decision to strike down that exclusion, *Devlin v. City of Philadelphia*, 862 A.2d 1234 (Pa. 2004), *aff'g in part and rev'g in part*, 809 A.2d 980 (Pa. Commw. Ct. 2002). The family exclusion does not apply if one of the parties is the estate of a deceased individual. *Meridian Trust Co. v. Commonwealth*, 149 Pa. Commw. 571, 613 A.2d 654 (Pa. Commw. Ct. 1992).

Unlike many of the other exclusions, the family exclusion applies without regard to whether consideration was given. Id. Thus, a sale of real estate between parent and child, for example, is not subject to realty transfer tax.

However, if a transfer is excluded because it is a family transfer and if the grantee makes a subsequent transfer within one year, the subsequent transfer is subject to tax as if the first grantor had made that subsequent transfer. §8102-C.3(6) (last clause). For example, suppose husband, H, transfers property to wife, W, who within one year of the transfer makes a subsequent transfer to her brother. The transfer from W to her brother is not considered to be an excluded sister-to-brother transfer. Rather, it is treated as a transfer from H to W's brother, who is not an excluded family member vis-à-vis H.

Property Passing by Testate or Intestate Succession

Section 8102-C.3(7) provides an exclusion for transfers for no or nominal consideration of property passing by testate or intestate succession from a personal representative of a decedent to the decedent's devisee or heir. There is no requirement that the devisee be related to the decedent or that the property be specifically devised rather than pass as part of the residuary estate. The regulations extend the exclusion to a document under an orphans' court adjudication allocating real estate to a surviving spouse as part of the family exemption or elective share if the document is for no or nominal consideration. 61 Pa. Code §91.159(a). Also excluded are transfers for no or nominal consideration from a trustee of a testamentary trust to a beneficiary to whom the property is devised or bequeathed. §8102-C.3(9.1). For a discussion of the exclusion for transfers from an inter vivos trust after the settlor's death, see the next section of this article.

However, a sale of real property by a personal representative or trustee is generally not excluded, even if the buyer is related to the decedent. For example, in *Meridian Trust Co. v. Commonwealth*, 149 Pa. Commw. 571, 613 A.2d 654 (Pa. Commw. Ct. 1992), the court held that real property purchased by the decedent's daughter under an option in the decedent's will was subject to tax because the transfer was for a sum that was not nominal. *Meridian Trust Co.*, 149 Pa. Commw. at 573, 613 A.2d at 655.

An exception to the general rule that a sale of real property by a personal representative or trustee is not excluded is found in RTT-02-036. In that ruling, one of the decedent's six children proposed to purchase real estate from the decedent's personal representative. The residue of the decedent's estate, which included the real estate at issue, was to be distributed under the decedent's will to his six children. The Department of Revenue noted that no realty transfer tax would be imposed if the personal representative distributed the real estate pro rata to the decedent's children and then five of the children sold their respective interests in the real estate to their sibling. The Department ruled that the proposed sale would not be subject to realty transfer tax under *Baehr Bros. v. Commonwealth*, 487 Pa. 233, 409 A.2d 327 (Pa. 1979) (concluding that a transfer that would otherwise be subject to realty transfer tax is not taxable when the transfer accomplishes what could have been accomplished by making two transfers, both of which would have been excluded from the tax).

It is not uncommon for heirs or devisees to receive an interest in real estate as tenants in common, joint tenants with right of survivorship or tenants by the entirety. As noted above, a transfer to heirs or devisees for no or nominal consideration is excluded. What if the heirs or devisees decide that they no longer want to jointly own the property? In that event, there is an exclusion for a division of the property among the joint tenants for no or nominal consideration; however, if any party takes a share greater in value than that party's undivided interest, tax is due on the excess unless another exclusion, such as the family exclusion, applies. §8102-C.3(5); 61 Pa. Code §91.159(b), Ex. 2.

The regulations also provide

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that if an interest in real estate would have passed to an heir or devisee by will or by intestacy but for that heir's or devisee's disclaimer or family agreement, the value of the disclaimed interest is not wholly excludable from tax unless either there is no or nominal consideration for the disclaimer or the conveyance is otherwise excludable from tax (*e.g.*, under the family exclusion discussed above). 61 Pa. Code §91.159(c).

Transfers to and from "Living Trusts" and "Ordinary Trusts"

In general, a transfer of real property to or from an inter vivos trust is subject to realty transfer tax. However, certain transfers for no or nominal consideration to or from "living trusts" and "ordinary trusts" are excluded. Although there is much uncertainty in this area, it is clear that a transfer to or from a trust that is wholly revocable by the transferor does not automatically mean that the transfer is excluded. Determining whether a transfer is excluded is a two-step process. One must first scrutinize the trust's provisions to determine whether the trust meets the realty transfer tax definition of a living trust or an ordinary trust. If the trust meets one of those definitions, the next step is to determine whether the transfer falls within one of the exclusions that applies to such trusts.

Statutory Provisions

Under the statute, a **"living trust"** is any trust, other than a business trust, intended as a will substitute by the settlor, that becomes effective during his or her lifetime, but from which distributions cannot be made to any beneficiary other than the settlor prior to the settlor's death. §8101-C.

It appears that the possibility – however remote – that a distribution can be made from the trust to any beneficiary other than the settlor during the settlor's lifetime will cause the trust to fail to meet the statutory definition of a living trust.

In general, an **"ordinary trust"** is any trust, other than a business trust or a living trust, that takes effect during the lifetime of the settlor and for which the trustees take title to property primarily for the purpose of protecting, managing or conserving it until distribution to the named beneficiaries of the trust. §8101-C. However, an ordinary trust does not include (i) a trust that has an objective to carry on business and divide gains, or (ii) a trust that either expressly or impliedly has <u>any</u> of the following five features: (1) treatment of beneficiaries as associates; (2) treatment of the interests in the trust as personal property; (3) free transferability of beneficial interests in the trust; (4) centralized management by the trustee or the beneficiaries; or (5) continuity of life. *Id.*

The second and fourth features, in particular, seem on their face to eliminate all or virtually all trusts from "ordinary trust" status. Even if one were to stretch for a sensible interpretation of the second and fourth features, certain trusts still would not qualify. For example, a trust that has no spendthrift provision would not qualify as an ordinary trust due to the free transferability of beneficial interests.

Unfortunately, the statutory definitions of living trust and ordinary trust do not appear to encompass many trusts commonly used in standard estate planning. The Department of Revenue has attempted on several fronts to provide guidance concerning the living trust and ordinary trust exclusions. In revised draft proposed regulations (hereinafter the "draft regulations"), the Department has eased the statutory requirements in certain respects.

Draft Regulations and Private Letter Rulings

For example, the Department's draft regulations fashion a definition of **ordinary trust** that stretches (perhaps beyond all recognition) for a sensible interpretation of the statute. Though the first part of the definition of ordinary trust in §91.101 of the draft regulations is largely consistent with the statutory definition,[14] there is a sharp divergence in the scope of the exclusions from the definition of ordinary trust. As set forth above, the statute excludes from the definition of ordinary trust a trust that has an objective to carry on business and divide gains or a trust that either expressly or impliedly has any of five enumerated features. In contrast, the draft regulations exclude the following:

1. Business trusts organized under the Associations Code, Massachusetts business trusts or associations[15] using the forms and methods of an ordinary trust which have either of the following features: (a) the treatment of beneficiaries as associates or (b) beneficial interests in the trust estate or profits that are evidenced by transferable shares, similar to corporate shares, or are otherwise treated as personal property;

2. Minors' estates;

3. Incompetents' estates;

4. A resulting or construc-

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tive trust created by operation of law; and

5. A testamentary trust.

The Department of Revenue's private letter rulings also appear to take a sensible approach to the issue of whether a trust qualifies as an ordinary trust. The Department has concluded in several rulings that the "garden-variety" trusts in those rulings constitute ordinary trusts. *See*, *e.g.*, RTT-04-026; -04-001; -03-029 (trusts were ordinary trusts because they became effective during the settlors' lifetimes and were designed to protect, manage and preserve the trust property for the beneficiaries). However, such rulings are binding only with respect to the taxpayer requesting the ruling and are valid for only 5 years. Many taxpayers would be able to proceed with greater comfort with transfers to garden variety trusts, without such a ruling, if the Department of Revenue adopts the definition of ordinary trust set forth in §91.101 of the draft regulations.

Although the draft regulations relax the statutory requirements for an ordinary trust, they appear to make it more difficult for a trust to qualify as a **living trust**. Under §91.101 of the draft regulations, a living trust is defined as an ordinary trust:

1. Which, throughout the settlor's lifetime, is revocable by the settlor without the consent of an adverse party;

2. Which vests no present interest in any of the trust assets in any person other than the settlor or trustee until the settlor's death;

3. All the income and corpus of which can be reached or materially affected by the settlor without revocation of the trust or the consent of an adverse party;

4. From which no transfer of property or money may be made by the trustee, at any time prior to the settlor's death, to any person (other than the settlor) in the capacity as beneficiary; and

5. Which the trustee (or, if the settlor was the trustee, the successor trustee) is required under the governing instrument to distribute the corpus and retained income upon the settlor's death.

The requirements to qualify a trust as a living trust under the Department of Revenue's private letter rulings are somewhat different from the requirements set forth in the draft regulations. *See, e.g.*, RTT-04-031; -04-021; -03-002. First, there is no requirement in the rulings, as there is in the draft regulations, that a trust qualify as an ordinary trust in order to qualify as a living trust. In those rulings, the Department set forth the following criteria for living trusts:[16]

1. The settlor must be free to change or revoke part or all of the trust during the settlor's lifetime.

The draft regulations do not indicate that the right to change the trust is sufficient. The author believes that the right to change the beneficiaries of the trust should be sufficient. In addition, the draft regulations are silent with respect to whether the right to partially revoke the trust is sufficient. In the author's opinion, the settlor's retention of the right to revoke (or change the beneficiaries of) solely that portion of the trust consisting of real estate should be sufficient.

2. The trust may not vest any present interest in the trust corpus or income to any person other than the settlor during the settlor's lifetime;

This requirement is exactly the same as the second requirement in the draft regulations except that the draft regulations clarify that the trustee, who has a legal interest in the assets of the trust, is not a problem.

Although it is not clear that a withdrawal right is considered an "interest" in a trust, a withdrawal right that is exercisable during the settlor's lifetime by someone other than the settlor is problematic. In many instances, a person granted a withdrawal right during the settlor's lifetime is a remainder beneficiary of the trust, in which case the trust would fail to meet the statutory requirement (and the fourth requirement of the draft regulations) that the trust be one from which distributions cannot be made to any beneficiary other than the settlor prior to the settlor's death. Even if the person granted the withdrawal right is not a beneficiary, the author does not believe that the Department of Revenue would conclude that the trust is a living trust.

3. The settlor must be the trustee of the trust, or in the case of the settlor's incapacity the settlor's guardian or other designee authorized to act on the settlor's behalf must be the trustee, or the trustee must be the settlor's nominee or appointee as designated in the trust instrument.

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The author is not aware of any ruling in which this requirement was not satisfied.

> 4. The trustee must have no discretion to distribute the trust corpus or income to anyone other than the settlor during the settlor's lifetime.

This requirement is discussed in more detail below. A trust provision that requires a distribution to someone other than the settlor during the settlor's lifetime arguably does not violate this requirement. It does, however, violate the fourth requirement of the draft regulations and the rulings' requirement, noted above, that the trust may not vest any present interest in the trust corpus or income to any person other than the settlor during the settlor's lifetime.

> 5. The trust must provide for the disposition of the trust corpus and accumulated income after the settlor's death.

The governing instrument need not provide that the trust property be distributed outright at the settlor's death; the trust may continue for other beneficiaries. *See* RTT-04-021; -04-020. Perhaps the only circumstance under which this requirement is not satisfied is where the governing instrument is silent with respect to the disposition of trust corpus and accumulated income after the settlor's death, in which case the trust property reverts to the settlor and is distributed as part of his or her probate estate. In the author's opinion, there is no reason to impose a transfer tax in that circumstance.

An example of a trust that fails to qualify as a living trust because it gives the trustee discretion to distribute the trust corpus or income to persons other than the settlor during the settlor's lifetime is found in private letter ruling RTT-03-003. The trust in that ruling provided that the trustee may in its discretion expend all or any part of the trust for the health, education, support or maintenance of the settlor or the settlor's spouse. The Department stated that the trust was not a living trust because the trustee of the trust "may distribute trust income and/or principal to the spouse of the settlor . . . before the settlor's death." The Department reached the same conclusion in RTT-03-002, where distribution from the trust to the settlor's spouse could only be made in the event of the settlor's incapacity.

However, in RTT-04-020, the Department reversed course with respect to its conclusion in RTT-03-002. RTT-04-020 involved the proposed transfer of husband's interest in real estate owned by him and his wife to trusts created by him. The trusts provided that, in the event of his incapacity, the trustees may pay so much of the income and principal to his spouse as the trustees in their sole discretion deem necessary for the health, support and maintenance of the spouse. His wife intended to transfer her interest in the real estate to reciprocal trusts. The Department concluded that the trusts did not violate the prohibition on giving the trustee discretion to distribute corpus or income to persons other than the settlor during the settlor's lifetime. The Department reasoned that distributions to the incapacitated settlor's spouse for his or her health, maintenance and support directly benefit the settlor because such distributions satisfy the settlor's legal support obligation.

Given that RTT-04-020 was issued on July 21, 2004 and the draft regulations, which contain no exception for trusts that authorize distributions to the settlor's spouse, are dated January 27, 2004, practitioners are left to wonder about the Department's current position regarding trusts that authorize distributions to the settlor's spouse only in the event of the settlor's incapacity. Adding further confusion is the "frequently asked questions" section of the Department's website, where the Department responds to a question by stating that a trust can be a living trust even if the trust instrument provides that the settlor's spouse may benefit during the settlor's lifetime. Although the Department's website response does not indicate that the spouse may benefit only during the settlor's incapacity, reliance on that fact is, in the author's opinion, exceedingly dangerous.

RTT-03-015 is another ruling in which the Department concluded that the trust did not violate the prohibition on giving the trustee discretion to distribute corpus or income to persons other than the settlor during the settlor's lifetime. The trust in that ruling granted the settlor total control over payments from the trust and apparently provided that if the trustees make a distribution to a third party, the distribution will be deemed a distribution to the settlor followed by a gift by the settlor to the third party.

Exclusions Applicable to Living and Ordinary Trust

If you have determined that a trust is a living trust that is an ordinary trust, the next step is to determine whether a transfer to or from the trust is excluded. The following transfers <u>for no or nominal consideration</u> are excluded by statute:

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1. To a **living trust** from the settlor of the trust, provided the recorder of deeds is presented with a copy of the trust instrument. §8102-C.3(8.1).

2. To an **ordinary trust** if the transfer would have been excluded had the transfer been made directly by the grantor to all of the possible beneficiaries that are entitled to receive the property or proceeds from the sale of the property, whether or not such beneficiaries are contingent or specifically named, provided the recorder of deeds is presented with a copy of the trust instrument that clearly identifies the grantor and all possible beneficiaries. §8102-C.3(8).

A transfer for no or nominal consideration by the settlor to an **ordinary trust** that provides for income to the settlor's son, S, for life, and then remainder to S's issue is excluded because a direct transfer to those beneficiaries would have been excluded under the family exclusion (discussed above). However, a trust instrument drafted by an experienced practitioner would likely provide for distribution of the remainder in the event none of S's issue survives S. If the trust provides that upon S's death, the remainder is to be distributed to S's then living issue, or if none, to S's church, the transfer to the trust is not excluded. Similarly, the transfer is not excluded if the settlor specifically names his or her niece to receive the remainder instead of the church. However, the tranfer is excluded if, instead of specifically naming his or her niece, the settlor provides that his or her intestate heirs are to receive the remainder. §8102-C.3(8)(second sentence, providing that a trust clause that identifies the contingent beneficiaries by reference to the heirs of the settlor as determined by the laws of intestate succession does not disqualify a transfer from this exclusion).

Note that under this exclusion, certain beneficiaries are disregarded. The only relevant beneficiaries are those "that are entitled to receive the property or proceeds from the sale of the property under the trust, whether or not such beneficiaries are contingent or specifically named." *Id.* For example, in *Leigh v. Commonwealth*, 645 A.2d 1346 (Pa. Cmmw. Ct. 1994), the court disregarded a beneficiary who was to receive the lesser of $5,000 or 1% of the principal when the settlor had funded the trust with real property worth $350,000 and other assets worth $170,000. If a beneficiary is not disregarded and a direct transfer to that beneficiary would not have been excluded, the entire transfer is subject to tax regardless of the remoteness or the size of the beneficiary's interest. *See Holmes v. Commonwealth*, 152 Pa. Commw. 193, 618 A.2d 1160 (Pa. Commw. Ct. 1992).

3. From an **ordinary trust** to a specifically named beneficiary who is entitled to receive the property under the recorded trust instrument or to a contingent beneficiary if the transfer of the same property would have been excluded had the transfer been made by the grantor of the property into the trust to that beneficiary. §8102-C.3(9).[17]

4. From a **living trust** to the settlor if the settlor originally conveyed such property to the trust. §8102-C.3(9.2).

5. From a **living trust** after the settlor's death to a beneficiary to whom the property is devised or bequeathed. §8102-C.3(9.1).

Any transfer of real property from a living trust during the settlor's lifetime is treated as a transfer made directly by the settlor to the grantee. §8102-C.3(9) (last sentence).

It is important to note that Philadelphia does not have an exclusion for transfers to or from living trusts. Although Philadelphia has exclusions for certain transfers to and from ordinary trusts, it does not define the term "ordinary trust."

In planning for transfers to and from trusts, practitioners continue to be faced with many uncertainties about the realty transfer tax rules. If the potential liability warrants it, a private letter ruling may be requested from the Department of Revenue.

Transfers from Trustee to Successor Trustee

A transfer for no or nominal consideration from a trustee to a successor trustee is excluded. §8102-C.3(10).

Transfers to Charitable and Other Nonprofit Organizations

There are only three narrow exclusions applicable to transfers to charitable and other nonprofit organizations.[18] One exclusion is for any transfer to a §501(c)(3) conservancy that has as its primary purpose the preservation of land for historic, recreational, scenic, agricultural or open-space opportunities. §8102-C.3(18). Another exclusion is for any transfer to a nonprofit industrial development agency or authority. §8102-C.3(14). The third exclusion

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Pennsylvania Realty Transfer Tax, continued

is for a transfer to a religious organization or other body or person holding title for a religious organization, but only if the transferor is a religious organization or other body or person holding title for a religious organization and such real property is not being or has not been used by such transferor for commercial purposes. §8102-C.3(17). The legislature has not seen fit to exclude any other transfer of real property to a charitable or other nonprofit organization. Exclusions for transfers from charitable and other nonprofit organizations are also very limited.

Partitions

Partitions of real property, whether by agreement or judicial action, into two or more distinct portions are not subject to realty transfer tax unless one of the tenants receives a portion that is greater in value than that tenant's prior interest. 61 Pa. Code §91.157.

Other Exclusions

The following transfers are also excluded:

• A transfer of a deed to a burial site that does not convey title to land but only a right to sepulcher and to erect monuments. 61 Pa. Code §91.193(b)(25).

• A transfer (1) for no or nominal consideration between principal and agent or straw party or (2) from or to an agent or straw party if no tax would have been due had the transfer been from or to the principal instead of the agent or straw party. §8101-C.3(10).

• A transfer to the Commonwealth of Pennsylvania or to any of its instrumentalities, agencies or political subdivisions by gift, dedication or deed in lieu of condemnation or deed of confirmation in connection with condemnation proceedings. §8102-C.3(1). Any other transfer (e.g., a sale) to the Commonwealth of Pennsylvania or to any of its instrumentalities, agencies or political subdivisions is subject to tax. Because the Commonwealth and its instrumentalities, agencies and subdivisions are exempt from the realty transfer tax, the other parties to the transaction bear liability for the entire tax due. §8102-C.2.

• A transfer for no or nominal consideration which corrects or confirms a transfer previously recorded but which does not extend or limit existing record legal title or interest. §8102-C.3(4).

As indicated above, there are numerous exclusions that are potentially applicable to transfers made in connection with estate planning and estate and trust administration. Proper planning is essential. For example, if a distribution of real estate from a trust to a beneficiary would be taxable, it is important that the trustee ascertain the beneficiary's intentions regarding the real estate. If the beneficiary intends to sell it shortly after its distribution from the trust and that sale would be taxable, it may be advisable for the trustee to sell the property in order to avoid the second payment of tax. In conclusion, whenever a transfer of an interest in real estate (or a transfer of an interest in an entity that owns real estate) is contemplated, the realty transfer tax ramifications should be carefully considered.

ENDNOTES

[1] The author would like to thank Wendi L. Kotzen of Ballard Spahr Andrews & Ingersoll, LLP for her helpful comments on this article.

[2] All references in this article to the realty transfer tax are to the Pennsylvania realty transfer tax unless otherwise specifically noted. The author has made no attempt to note all of the numerous differences between the Pennsylvania and Philadelphia realty transfer taxes.

[3] All section references in this article are to title 72 of the Pennsylvania Statutes unless otherwise specifically noted.

[4] §8101-C. The term "corporation" is defined in §8101-C. In general, limited liability companies and business trusts are corporations for this purpose. Id.; see 15 Pa. C.S. §8925(a). An association is a partnership (general or limited) or any other form of unincorporated enterprise, owned or conducted by two or more persons other than a private trust or decedent's estate. §8101-C.

[5] Interests owned by a trust are considered owned by the remaindermen and interests owned by an estate are considered owned by the specific devisee or the residuary devisee, as the case may be, but there is no look-through rule with respect to interests owned by a corporation or association. 61 Pa. Code §91.202(b)(2)-(4).

[6] The gross receipts test is based on the entity's fiscal year immediately preceding the valuation date. 61 Pa. Code §91.201(b)(5).

[7] 61 Pa. Code §91.201(a)(2); (b)(1). The threshold is 50% under Philadelphia Code §19-1402(11)(a)(ii). For purposes of the definition of real estate company under the Philadelphia Code, the situs of the real property need not be in Philadelphia. Philadelphia Code §19-1402(11)(c).

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Pennsylvania Realty Transfer Tax, continued

[8] §8102-C.5(a). Multiple transfers of a particular interest count only once toward the 90% threshold. 61 Pa. Code §91.202(b), Ex. 2. A transfer of an ownership interest between members of the same family is not considered a change in the ownership of the interest. 61 Pa. Code §91.202(c). See note 10 infra for the definition of "members of the same family."

[9] §8102-C (last sentence); 61 Pa. Code §91.113(a); §8102-C.5(c). Real estate companies are not the only entities upon which realty transfer tax may be imposed. The tax is also imposed on family farm corporations ("FFCs") and family farm partnerships ("FFPs") that dissolve or cease to meet the requirements to be defined as such because of the issuance or transfer of ownership interests or the acquisition or transfer of the entity's assets that are devoted to the business of agriculture. §8102-C.5(b), (b.1), (c). However, transfers between members of the same family of an ownership interest in a FFC or FFP are excluded. §8102-C.3(20). See note 10 infra for the definition of "members of the same family." Similarly, transfers of real estate devoted to the business of agriculture to a FFC or FFP by a member of a family that directly owns at least 75% of each class of the stock thereof (or, in the case of a FFP, the interests in the partnership) are excluded. §8102-C.3(19); (19.1).

[10] "Members of the same family" are "[a]ny individual, such individual's brothers and sisters, the brothers and sisters of such individual's parents and grandparents, the ancestors and lineal descendants of any of the foregoing, a spouse of any of the foregoing and the estate of any of the foregoing." §8101-C. That definition encompasses many relationships that do not fit within the family exclusion, which is discussed later in this article. Thus, for example, an individual and his or her nieces, nephews, aunts, uncles and cousins are members of the same family, but a transfer of real estate between an individual and any of the foregoing persons does not fit within the family exclusion. Of the relationships that fit within the family exclusion, only one – former spouses – does not fit within the definition of members of the same family.

[11] §8102-C.3(13). The Philadelphia realty transfer tax exclusion for transfers of real estate from an entity to its owners is much narrower. The Philadelphia exclusion applies only to transfers of real estate effectuated pursuant to a plan of liquidation and dissolution to the extent the value of the real estate is attributable to the ownership interest of persons who filed a Certificate of Transfer and paid realty transfer tax upon the acquisition of the ownership interest. Philadelphia Code §19-1402(14)(b).

[12] The regulations broaden the exclusion to encompass any transfer between a lineal ascendant and descendant (or spouse of such descendant). 61 Pa. Code §91.193(b)(6)(i)(D). Thus, a transfer between great-grandparent and great-grandchild or his or her spouse is excluded.

[13] §8102-C.3(6). Transfers of real estate between "members of the same family," as defined in §8101-C, are not excluded unless the relationship falls within one of the relationships specified in §8102-C.3(6).

[14] Under the draft regulations, an ordinary trust is defined as a private trust that takes effect during the settlor's lifetime and for which the trustees take title to property primarily for the purpose of protecting, managing or conserving trust assets, under the ordinary rules applied in the orphans' court division, until distribution to the beneficiaries of the trust. However, the statutory, but not the regulatory definition of ordinary trust, excludes any trust that is a living trust.

[15] The term "association" in §91.101 of the draft regulations excludes ordinary trusts and living trusts.

[16] This article presents the ordering of the criteria differently from the Department's rulings. The ordering in this article more closely parallels the ordering in the draft regulations.

[17] In RTT-04-015, the Department concluded that the exclusion in §8102-C.3(9) did not apply under the facts of that ruling. Although the Department's statement that the proposed transferee was not a beneficiary was wrong – the proposed transferee had the right under the trust instrument to use and reside in the trust property during his lifetime – the Department correctly ruled that the exemption did not apply. The proposed transferee was not the type of beneficiary required for the exemption to apply – a specifically named beneficiary entitled to receive the property under the recorded trust instrument or a contingent beneficiary. Although the proposed transferee was entitled use and reside in the property, the proposed transferee was not entitled to receive the property itself.

[18] Philadelphia allows several additional narrow exclusions for transfers to charities and other nonprofit organizations.

Revisions to the New Jersey Probate Code

By CHARLES H. WAMPOLD, III AND DAVID A. GOLDFARB
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New Jersey has substantially revised its probate code, N.J.S. 3B:1-1 et seq.. These revisions, which are based on the 1991 Uniform Probate Code, became effective on February 27, 2005. While most of the provisions are technical in nature, some represent a substantial change from current law. This article surveys some of the most important changes.

I. Scope of New Code

The new code effects substantial changes to Title 3B Chapter 1 (definitions), Chapter 3 (execution of wills and construction of governing instruments), Chapter 5 (intestacy), Chapter 7 (slayers), Chapter 9 (disclaimers), Chapter 17 (non-judicial settlement of accounts), and Chapter 22 (creditors). The new code does not include the provisions of the Uniform Probate Code relating to the surviving spouse's election against the will. New Jersey's elective share statute, N.J.S. 3B:8-1 et. seq., remains unchanged. The new code also makes no change to Chapter 18 (fiduciary commissions).

Perhaps the most sweeping change appears in the definitions section of the code. By including a new definition of "Governing instrument" in N.J.S. 3B:1-1, the new probate code will apply not only to wills, but also to deeds, trust instruments, insurance or annuity policies, joint and pay-on-death accounts, retirement plans, instruments creating powers of appointment or powers of attorney, "or a dispositive, appointive, or nominative instrument of any similar type." Thus, for instance, under the new code, a divorce would revoke not only a bequest to a divorced spouse under a will but also a designation of a divorced spouse as a beneficiary on an insurance policy. Obviously, the new probate code cannot preempt federal law; therefore, one must consider carefully the effect that the new probate code will have on retirement plan beneficiary designations that are subject to ERISA or other federal laws.

II. Writings Intended as Wills

The new probate code provides a new and fertile source of probate litigation by adding a new category of testamentary documents, "writings intended as wills." Such documents, which do not otherwise qualify as witnessed or holographic wills, will nevertheless be treated as a will "if the proponent of the document or writing establishes by clear and convincing evidence that the decedent intended the document or writing to constitute: (1) the decedent's will; (2) a partial or complete revocation of the will; (3) an addition to or an alteration of the will; or (4) a partial or complete revival of his formerly revoked will or formerly revoked portion of the will." N.J.S. 3B:3-3. Note that there is no requirement that any portion of a writing intended as a will be in the testator's handwriting. Indeed, there is no explicit signature requirement. Also, the statute provides no definition of "document." It therefore remains to be seen whether media such as computer files, tape recordings or video images may qualify as writings intended as wills.

III. Governing Instrument Construction

N.J.S. 3B:3-41 is amended in the new probate code to provide that descendants shall take by representation unless there is a contrary provision in a will or trust instrument. Under the law in effect prior to February 27, 2005, descendants take per stirpes unless another method is specified. "By representation," or "per capita at each generation" is defined in N.J.S. 3B:1-2 to mean that all takers in the same generation share equally, even if there are takers in more than one generation. Thus, in a case where two of the decedent's three children have predeceased, and one predeceased child is survived by one son, and the other predeceased child is survived by three daughters, the surviving grandson (and each of the three surviving granddaughters) takes a one-sixth share by representation; he takes a one-third share if the property passes per stirpes.

The new probate code also includes in N.J.S. 3B:1-2 a definition of "Stepchild": "a child of the surviving, deceased, or former spouse of the testator." If this definition is construed literally, then a class gift to "my stepchildren" in a governing instrument will include not only stepchildren in existence

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during the time of the decedent's marriage but also children born to the decedent's former spouse after their divorce – a result that most would view as anomolous. Thus, if the term "stepchildren" is used in a governing instrument, in most cases it will be advisable for the draftsman to provide a clear definition of the term and not to rely upon the statutory definition. The new probate code also adds stepchildren to the anti-lapse statute, N.J.S. 3B:3-35.

The requirement that a beneficiary survive the decedent by 120 hours, which had been the default provision only for wills, will be extended to all governing instruments and also to future interests. N.J.S. 3B:3-32. This requirement may be overridden by a specific provision in the governing instrument directing otherwise. N.J.S. 3B:3-32(d). An after-born heir will be required to survive by 120 hours after birth in order to be treated as living during gestation. N.J.S. 3B:5-8.

Provisions addressing the entitlement of a child omitted from a will executed prior to the birth or adoption of the child are modified by 3B:5-16 of the new probate code. Under prior law, such an omitted child would, as a general rule, be entitled to the amount he or she would have received in the case of an intestacy. Under the new code, the amount an omitted child may receive is limited to the lesser of his or her intestate share or the amount "that the child would have received had the testator included all omitted after-born and after-adopted children with the children to whom devises were made under the will and had given an equal share of the estate to each child." The code does not direct how the omitted child's share is to be calculated in a case where, for instance, one child is given an outright bequest and another child is given an interest in trust.

The effect of a divorce or annulment is broadened under N.J.S. 3B:3-14. Except as provided by the express terms of a governing instrument, a court order, or a contract relating to the division of the martial estate, a divorce or annulment will revoke all revocable dispositions or appointments in any governing instrument executed before the divorce or annulment to the decedent's former spouse or to any relative of the decedent's former spouse. (A relative of the decedent's former spouse does not include a person who was also a relative of the decedent after the divorce or annulment.) All such revocations are treated as if the former spouse or the former spouse's relatives had disclaimed the revoked provisions. A divorce or annulment will convert joint tenancies with the right of survivorship or tenancies by the entireties into tenancies in common. A divorce or annulment will also revoke any appointment of the former spouse or a relative of the decedent's former spouse to serve in any fiduciary or representative capacity. Such appointments will be treated as if the former spouse or the former spouse's relatives had died immediately before the divorce or annulment. Remarriage to the former spouse restores all revocations that had resulted from the divorce or annulment.

IV. Intestacy

Descent by intestacy will change dramatically under the new probate code. In the case where a decedent is survived by a spouse and descendants, all of whom are also descendants of the surviving spouse, and no other descendant of the surviving spouse survives the decedent, the entire intestate estate will pass to the surviving spouse. N.J.S. 3B:5-3(a)(2). Under the previous law, the surviving spouse would have received the first $50,000 plus one-half of the balance; the remaining assets would have passed to the descendants of the decedent.

Where a decedent is survived by a spouse and parent(s) but no descendants, the spouse will receive the first 25% of the intestate estate (but not less than $50,000 nor more than $200,000) plus 75% of the balance; the remaining balance will pass to the parent(s). N.J.S. 3B:5-3(b). Under the previous law, the spouse would have received only $50,000 plus 50% of the balance.

In cases where a decedent is survived by a spouse and one or more descendants, and either spouse has a descendant who is not also a descendant of the other, the surviving spouse will receive the first 25% of the intestate estate (but not less than $50,000 nor more than $200,000) plus 50% of the balance; the balance will pass to the descendants of the decedent. N.J.S. 3B:5-3(c). Under the previous law, the spouse would have received only 50% of the intestate estate.

Stepchildren (as defined above) may become intestate heirs under the new probate code, but only if the decedent has no spouse and there are no surviving descendants of the decedent's grandparents. N.J.S. 3B:5-4(f). In such circumstances under the previous law, stepchildren would have received nothing; all of the intestate property would have escheated to the State of New Jersey.

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Under the new probate code, all intestate shares that pass to descendants of the decedent's parents or grandparents will pass by representation (per capita at each generation). N.J.S. 3B:5-6. Under previous law, if the takers were of unequal degrees of kinship, those of more remote degree would take per stirpes.

V. Slayers

The intentional killing of the decedent will revoke any of the decedent's revocable dispositions in a governing instrument to the slayer or to a relative of the slayer and any appointment of the slayer or relative of the slayer as a fiduciary or representative, and converts the interests held by the decedent and the slayer as joint tenants with right of survivorship into tenancies in common. For this purpose, slayers and their relatives (who are not also related to the decedent) are treated as if they had disclaimed their interest under the governing instrument or, for fiduciary or representative appointments, as if they had predeceased the decedent. 3B:7-1.1 et seq.

VI. Disclaimers

The new probate code clarifies and expands provisions under previous law involving disclaimers, including disclaimers of inter vivos transfers that had been addressed previously in N.J.S. 46:2E-1 et. seq. but are now incorporated into the new code in N.J.S. 3B:9-2(b). The new probate code allows disclaimers by a surviving joint tenant without regard to the extent, if any, that the surviving joint tenant contributed to the creation of the joint interest. N.J.S. 3B:9-2(c). Furthermore, the new probate code clarifies that joint property is deemed to consist of a present interest and a future interest that is defined as the right of survivorship. N.J.S. 3B:9-1(e). A disclaimant will be treated as never having received the disclaimed interest. N.J.S. 3B:9-8.

Under previous law, unless extended by the court, the right to disclaim expired nine months after the decedent's death or the vesting of a future interest. The new probate code repeals that provision and allows disclaimers to be made at any time before the right to disclaim is otherwise barred. N.J.S. 3B:9-4. The time for making a qualified disclaimer under federal requirements will not be changed, however. N.J.S. 3B:9-14.

The criteria for barring the right to disclaim are set forth in N.J.S. 3B:9-9, which generally incorporates many of the reasons for barring disclaimers under the previous law notwithstanding that nine months had not yet passed. The new probate code specifies that a beneficiary shall not be barred from disclaiming all or any part of the balance of property even after the beneficiary has received a portion of the property, N.J.S. 3B:9-9(b), and specifies that "a bar to the right to disclaim a present interest in joint property does not bar the right to disclaim a future interest in that property." N.J.S. 3B:9-9(c). Note that in many instances a disclaimer may be valid for New Jersey purposes but not for federal purposes. See Reg. § 25.2518-2.

The new probate code extends the right to disclaim to a fiduciary or to an agent acting on behalf of a principal under a power of attorney. It also adds a new provision allowing any fiduciary or agent to disclaim any power or discretion held by such fiduciary or agent in a fiduciary capacity. In all cases where disclaimers are to be made by a fiduciary or an agent, court approval is required unless the governing instrument specifically allows such disclaimers without court approval. Court approval shall be granted if the court finds that the disclaimer is advisable and will not materially prejudice the rights of creditors, devisees, heirs, beneficiaries, or the principal on whose behalf the agent is acting. N.J.S. 3B:9-4. 3B:9-4.1.

Unless the governing instrument provides otherwise, the disclaimed property passes as if the disclaimant had predeceased the decedent or, in the case of future interests, as if the disclaimant had died before the event determining that the taker of the property or interest is finally ascertained and the taker's interest is vested. N.J.S. 3B:9-8.

VII. Non-Judicial Settlement of Accounts

The new code helps facilitate informal settlements of a fiduciary's account by adding new section 3B:17-13, which provides:

> "Unless the governing interest expressly provides otherwise, an instrument settling or waiving an account, executed by all persons whom it would be necessary to join as parties in a proceeding for the judicial settlement of the account, shall be binding and conclusive on all other persons who may have a future interest in the property to the same extent as that instrument binds the person who executed it."

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It would appear that this section makes the court rules pertaining to virtual representation applicable to informal settlements. *See*, R. 4:26-3.

IX. Creditors

The new probate code provides that unless a creditor submits a claim within nine months of the decedent's death, the personal representative is not liable to that creditor with respect to any assets delivered or paid in satisfaction of lawful claims, devises or distributive shares prior to the presentation of that creditor's claim. N.J.S. 3B:22-4. This is a change from the previous law, which required publication of an order to limit creditors in order to provide similar shelter from liability; the order to limit creditors required presentation of claims within six months of the date of the order, however.

X. Conclusion

New Jersey's new probate code provides some welcome uniformity to the treatment of wills and the vast array of "will substitutes." It also makes the rules of intestate descent conform better to modern sensibilities. In many areas - such as disclaimers and non-judicial settlement of accounts - the new code brings some highly desirable liberalization of the probate laws. In some instances - such as the recognition of "writing intended as wills" – the cost of liberalization will undoubtedly be greater uncertainty and controversy.

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the presentation on October 11 will deal with attorney and fiduciary compensation.

4. The Publications Committee will be chaired in 2005 by Bob Louis after the "retirement" of Susan Collings, who tirelessly published our newsletter for the past four years, The committee will distribute the newsletter electronically; the savings for the Section in printing and postage are substantial.

5. The Ad Hoc Outreach Committee will continue its excellent work, led by Kathy Mandelbaum, establishing connections with law students and young practioners, with an ambitious plan to reach out on multiple levels.

6. The Taxation Committee, led this year by Matt Rosin, will continue to present timely discussions of federal and state tax developments and practice tips at its monthly meetings.

7. The Public Service Committee, led by Howard Vigderman, will embark in 2005 on a mission to spread the word of the pro bono contributions of the members of the Section, as well as continue to act as a clearing-house for requests that come to the Section for participation in various pro bono activities.

8. Newly-formed committees, chaired by Karin Kinney and Lawrence Norford, respectively, will reach out to members interested in the concerns of Closely Held Business and Dispute Resolution.

As always, there is much going on in the Probate Section. If you have ideas, suggestions, questions or comments, please let us hear from you.

TAX UPDATE

By JOAN AGRAN
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I. TREASURY REGULATIONS

Final Regulations Under Code Sec. 2032 Issued

In T.D. 9172, 70 Fed. Reg. 295 (1/4/05), the Treasury issued final regulations providing guidance to estates making Code Sec. 2032 alternate valuation date elections to reflect changes made to Code Sec. 2032 by the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986.

The final regulations clarify that in evaluating an estate's qualification for the Code Sec. 2032 election, the determination of whether there has been a decrease in both the value of the gross estate and in the sum of the estate and generation-skipping transfer (GST) tax liability, as reduced by credits allowable against these taxes, is made with reference to the estate and GST tax payable by reason of the decedent's death. The final regulations also provide that a protective alternate valuation election may be made on decedent's estate tax return and will apply if it is subsequently determined that the estate meets the Code Sec. 2032(c) eligibility requirements. A protective election is irrevocable as of the due date of the return, including extensions of time actually granted.

The final regulations allow estates to request extensions of time to make the Code Sec. 2032 election under Reg. §301.9100-1 and Reg. §301.9100-3 even after the expiration of the one-year period; such relief may be granted (subject to the requirements of those sections) if the estate files the estate tax return no later than one year after the filing due date, including extensions actually granted.

The final regulations are effective for decedents dying on or after January 4, 2005. However, the final regulations allow taxpayers to apply the provisions retroactively if the Code Sec. 6511 statute of limitations for filing a credit or refund claim for estate or GST taxes has not expired.

Treasury Finalizes Gift Tax Valuation Rules For Qualified Interests in Trusts

In T.D. 9181, 70 Fed. Reg. 9222 (2/25/05), the Treasury finalized, with limited changes, the proposed regulations amending the Code Sec. 2702 regulations to conform them with, or clarify them based on, the holdings in *Walton v. Comr.*, 115 T.C. 589 (2000) and *Schott v. Comr.*, T.C. Memo 2001-110, *rev'd and rem'd*, 319 F.3d 1203 (9th Cir. 2003).

The final regulations amend the regulations under the gift tax special valuation rules to provide that a unitrust or annuity interest payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies prior to the expiration of the term, is a qualified interest for the specified term. The final regulations clarify that the exception treating a spouse's revocable successor interest as a retained qualified interest applies only if the spouse's annuity or unitrust interest, standing alone, would constitute a qualified interest that meets the requirements of Regs. §25.2702-3(d)(3), but for the grantor's revocation power. Language has also been added to Reg. §25.2702-3(e), Example 8 to clarify that the grantor makes a completed gift on expiration of his retained term (the grantor having survived the term and not having exercised the revocation right). The regulations are effective July 26, 2004.

II. COURT DECISIONS

Retirement Accounts Not Discounted for Beneficiaries' Potential Income Tax Liabilities

In *Smith Est. v. U.S.*, 95 AFTR 2d 2004-6891, decedent died in 1997. The estate timely filed an estate tax return reporting the decedent's interest in two retirement accounts and paid tax due of $140,358. In 1999, the estate timely filed a claim for refund of $78,731 of estate tax on the ground that it overvalued the retirement accounts. In the supplemental return that was filed, the estate discounted the value of the retirement accounts by 30% to reflect the income taxes the beneficiaries would pay on distributions from the accounts. The Service denied the refund and the estate sued in district court, where it lost on summary judgment. The estate then appealed to the Fifth Circuit.

The estate argued that the value of the assets in the retirement accounts should be discounted to reflect the federal income tax liability to the beneficiaries upon

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distribution from the accounts. The Fifth Circuit applied the willing buyer-willing seller test, stating that the test is an objective one—the hypothetical parties are not the estate and the beneficiaries of the retirement accounts. The Court said that correctly applying the willing buyer-willing seller test demonstrates that a hypothetical buyer would not consider the income tax liability to a beneficiary on the IRD since he is not the beneficiary and thus would not be paying the income tax.

In addition, the Fifth Circuit said that Congress addressed the estate's concern over the double tax through the Code Sec. 691(c) deduction. Thus, it held that the district court properly concluded that the retirement accounts could not be discounted to reflect the income tax the beneficiaries would have to pay on distributions.

Estate Denied Summary Judgment on §2053 Deduction for Interest on Loan to Pay Estate Taxes

In *Rupert v. U.S.*, 95 AFTR 2d 2005-991 (M.D. Pa. 2004), at age 79, the decedent won the Pennsylvania lottery and began receiving annual payments of approximately $630,000, which were to continue for 21 years. Decedent established a savings trust to save for the anticipated estate taxes that would be due at her death and a lottery trust to receive the lottery winnings.

When Decedent died six years later, the present value of the remaining lottery payments was approximately $5.6 million, while her other estate assets totaled approximately $1.4 million. The savings trust had a balance of approximately $1.2 million. To make up the difference of approximately $1.7 million in the estate taxes owed by decedent's estate, approximately $1.7 million was borrowed from a bank with the future lottery winnings as the only source of payment for the loan.

The estate filed a protective refund claim with the Service asserting that the estate had a right to a refund equal to the estimated amount of total future interest payments on the loan. The estate filed supplemental estate tax returns claiming a refund of the interest actually paid in 2000-2002. The Service did not pay or deny the claims. The estate then sued the government for the refunds, claiming that the estate should be able to deduct the interest as a Code Sec. 2053(a)(2) administration expense. The estate also sought to establish the estate's right to deduct future payments of interest as paid and made certain.

The district court denied the estate's summary judgment motion. After determining that Pennsylvania law permits the sale of lottery winnings, the court explained that this does not mean that the loan was unnecessary. However, the estate had failed to show that the interest expense was necessary by illustrating that the loan avoided some harm to the estate. Such evidence could be supplied by showing that the sale of the lottery payments would be the equivalent of a forced sale of stock.

Buy-Sell Agreements Using Book Values Do Not Control Estate and Gift Tax Values

In *True Est. v. Comr.*, 94 AFTR 2d 2004-7039 (10th Cir. 2004), the decedent and his wife established a number of companies that were governed by pre-Chapter 14 buy-sell agreements. Upon the occurrence of an offering event, the shareholders were required to purchase the departing shareholder's interest at formula prices listed in the agreements. The formula prices were derived from a calculation of the respective company's book value, which each company used for its records in lieu of generally accepted accounting principles (GAAP). The companies' book values tended to be much lower than what would be calculated under GAAP and did not always represent fair market value for liquidation purposes.

Beginning in 1971 and continuing over the years, decedent and his wife gave and sold various interests in the family companies to their children, based on book values pursuant to the buy-sell agreements. When decedent died in 1994, his remaining interests in the companies were transferred to his wife and children at book value. Decedent's estate reported his interest in the family companies at an amount equal to the proceeds the estate would receive under the buy-sell agreements.

The Service determined that the values of the family companies were higher than the book values used in the transactions and assessed gift and estate tax deficiencies of over $75 million and undervaluation penalties of over $30 million for 1993 and 1994. Decedent's estate and his wife argued that the book values and other restrictive terms detailed in the buy-sell agreements established the values of the transferred interests for estate and gift tax purposes. The Tax Court rejected the taxpayers' argument and determined that the value of the transferred interests, based on expert appraisals and other evidence presented at trial, substantially exceeded the amounts claimed by taxpayers, resulting in tax deficiencies of approximately $18.2 million and penalties of

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approximately $3.1 million.

On appeal, the Tenth Circuit affirmed the Tax Court's judgment, stating that the Tax Court did not err in finding that the price terms in the buy-sell agreements did not control for estate or gift tax valuation purposes. The Tenth Circuit also concluded that the Tax Court's application of a general marketability discount in valuing the transferred interests adequately took into account the buy-sell agreement restrictions.

The court found that, as developed in the case law and embodied in Regs. §20.2031-2(h), the buy-sell agreements served as testamentary substitutes intended to pass on the decedent's interests to the natural objects of his bounty for less than full and adequate consideration. The court further ruled that the inter vivos transfers were not exempt from the gift tax as sales, exchanges, or transfers made in the ordinary course of business pursuant to Reg. §25.2512-8.

Remainder Interest In Trust Not Included in Decedent's Estate

In *Cameron v. U.S.* 94 AFTR 2d 2004-5404(DC PA 2004), the decedent's sister created two trusts during her life for her and the decedent's benefit. Upon the death of the survivor of the two sisters, the two trusts were to terminate and the trust property was to be distributed under the terms of the residuary clause of sister's Will. The Will provided that the residue of sister's estate was to pass 50% to decedent and 50% was to be divided among three other individuals. Sister's Will also provided that, if decedent predeceased her, or if she died under circumstances making it difficult to determine who died first, neither decedent nor her estate were to receive anything. Sister predeceased decedent.

On decedent's death, the Service, interpreting the language of sister's Will literally, took the position that a 50% remainder interest in the trust was includible in decedent's gross estate. The Service argued that, because sister had predeceased decedent, decedent's later death caused the trust to terminate and its assets to be distributed in accordance with the terms of the residuary clause of sister's Will, which left 50% of her estate to decedent.

Decedent's estate took the position that sister's intent concerning disposition of the trust property on her death had to be derived from her entire testamentary scheme, which, the estate argued, indicated that sister's primary concern was to provide for herself and decedent until the death of both of them, but there was no evidence that sister intended to give decedent a posthumous right to direct the ultimate disposition of any of the trust assets.

The district court agreed with the estate, finding that although decedent's death terminated the trust and triggered the provision in sister's Will that 50% of her estate be distributed to decedent, when viewed in the light of all of sister's testamentary documents, this did not show that sister intended to leave 50% of her estate to decedent's estate. Decedent's death meant that she was unable to take as a beneficiary and therefore the residue passed to the other named individuals.

Valuation Of Closely Held Stock Based On Post-Death Events Upheld

In *Estate of Helen M. Noble, et al. v. Commissioner*, TC Memo 2005-2 (2005), decedent died in 1996 and the estate filed an estate tax return in July 1998. The return reported as part of the assets 116 shares of closely held bank stock, which were part of 1,000 nonpublicly traded shares of the only class of stock that the bank had outstanding at the time of decedent's death and which represented an 11.6% interest in the bank. The return reported a value of $903,988 for the stock, resulting from the fair market value of the stock equal to its 1996 book value less a 45% minority interest discount.

Bancorporation (owned by three shareholders, all unrelated to decedent) owned the remaining 88.4% interest in the bank. A Bancorporation shareholder sought to buy the 116 bank shares held by the estate for $878,004, based on a written appraisal obtained by the shareholder for the fair market value of those shares as of December 31, 1996. The estate declined to sell its shares at this appraised price. The estate ultimately sold those shares to Bancorporation in October 1997 for $1.1 million.

In July 2001, the Service issued to the estate a notice of deficiency, determining that the fair market value of decedent's 116 bank shares was $1.1 million. Subsequently, at trial, both parties called expert witnesses to value the shares. The Service's expert ascertained a fair market value of $1.1 million by considering four valuation methods and applying a 15% minority interest discount and a 30% lack of marketability discount to the values derived under those methods. The principal expert witness for the estate ascertained a fair market value of $841,000 by considering five valuation

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methods and applying a 43% lack of marketability discount to the marketable minority interest value.

The Tax Court held that the fair market value of the interest was $1,067,000. Noting that an appeal of this case would go to the Eighth Circuit, and citing *Fitts Est. v. Comr.*, 237 F.2d 729 (8th Cir. 1956), the Tax Court explained that in determining the value of unlisted stocks, actual sales made in reasonable amounts at arm's length, in the normal course of business, within a reasonable time before or after the valuation date, are the best criterion of market value. The court determined that in this case the sale was freely negotiated, was at arm's length, and neither the estate nor Bancorporation was compelled to buy or to sell. In addition, the sale occurred sufficiently close to the applicable valuation date and no material change in circumstances had occurred between the valuation date and the date of the sale that would have affected the fair market value of the subject shares. Therefore, the court concluded that the sale was the best indicator of the fair market value of decedent's shares at the time of her death.

Estate Denied QTIP Deduction

In *Davis Est. v. Comm.*, 95 AFTR 2d 2005-667 (9th Cir., 2005), in 1993 decedent executed a will and a declaration of trust. The will bequeathed the residue of the decedent's estate to his two daughters. The declaration of trust was for decedent's benefit during his lifetime and named his two daughters as successor beneficiaries following decedent's death. If either daughter predeceased decedent, her interest would pass to her descendants, per stirpes.

Sometime later, the decedent married, and in 1996, he executed a codicil and an amendment to the declaration of trust. The amendment gave a life estate to his surviving spouse and directed the trustee to pay to, or apply for the spouse's benefit the net income of the trust as the trustee determined to be proper for the health, education, or support, maintenance, comfort and welfare of the spouse in accordance with her accustomed manner of living. The trustee was further directed to consider spouse's other sources of income in making distributions to the spouse and to invade the trust principal if the income was insufficient. The amendment also designated the spouse as the decedent's successor trustee.

Decedent died in 1997, leaving a gross estate of $1,180,823. The estate claimed a marital deduction in the amount of $564,862, but the Service reduced the deduction to $8,354, the amount of life insurance proceeds that passed directly to her, and issued a notice of deficiency in the amount of $220,593.

The Tax Court held that the interest received by spouse did not qualify for the Code Sec. 2056(b)(7) exception because the spouse was not entitled to all of the income for life under the terms of the amended trust.

The Ninth Circuit affirmed the decision of the Tax Court. Looking first to state law, the court found that when read as a whole, the declaration of trust and the amendment unambiguously indicated that the decedent intended to leave to his spouse an interest in the trust income explicitly restricted by the purposes listed in the trust. In contrast, decedent gave himself an unrestricted right to "all of the net income" from the trust estate without any limiting terms, indicating that decedent intended to bequeath his spouse a more limited interest than he had during his own life.

In addition, the court found that neither the declaration of trust nor the amendment contained any language suggesting that decedent intended that the interest passing to spouse should qualify for a marital deduction under Code Sec. 2056(b)(7), and, thus the trust would not be reformed to comply with the QTIP requirements. Finally, although spouse was the sole trustee, this did not save the otherwise defective trust for two reasons: (i) when acting as trustee, spouse can properly only make such distributions to herself as are permitted by the amendment, and (ii) the possibility, however remote, that the surviving spouse might resign or become incapacitated prevents a provision naming the surviving spouse as trustee from automatically qualifying an otherwise deficient trust for the marital deduction under Code Sec. 2056(b)(7).

III. IRS REVENUE RULINGS, REVENUE PROCEDURES AND NOTICES

Service Provides Intestate Takers Help In Uncovering Decedent's Assets

The Service has issued Rev. Rul. 2004-68, 2004-31 IRB 118, to assist individuals who inherit from an intestate deceased relative and cannot locate assets held by the decedent. The ruling describes the conditions under which they are permitted to examine the decedent's previously filed income tax returns to find missing assets.

Under Code Sec. 6103(e)(3)(B), the income tax return of a decedent is, upon written request, open to inspection by, or disclosure to, any heir at law, next of kin, or

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beneficiary under the will of such decedent, or a donee of property, if the Service finds that such individual has a material interest that will be affected by information contained therein, generally interpreted as an important interest that is financial in nature. The ruling clarifies that an heir at law or next of kin who is a distributee under state law of the estate of an intestate decedent has such a material interest.

In addition to a written request for inspection or disclosure, a person requesting access under Code Sec. 6103(e)(3)(B) must provide the Service with (i) proof of the date and place of death, and state of decedent's residence to help determine which state law is applicable, and proof of his or her relationship to the decedent, and (ii) a written statement, along with supporting documents to demonstrate that he has a material interest that will be affected by information contained in each requested return, such as a copy of the petition for probate or other comparable pleading required to institute the proceeding for the administration of the decedent's estate.

IV. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

No Charitable Deduction For Bequest To Nun, Then Turned Over To Religious Order

In PLR 200437032, decedent executed a will naming his sister, a nun who many years before had taken a vow of perpetual poverty, as executrix and residuary beneficiary of his estate. The residue, consisting of cash and securities, would go to a designated religious order if the nun predeceased her brother. More than nine months after decedent's death, in her capacity as executrix and consistent with her vow of poverty, the nun transferred cash and title to the securities to the religious order, an organization described in Code Sec. 2055(a)(2) to which bequests are deductible under Code Sec. 2055.

The estate took the position that the nun's vow satisfied the requirements for a Code Sec. 2518 qualified disclaimer because (i) her vow was a written, irrevocable and unqualified refusal to accept the bequest, (ii) she was the executrix of decedent's estate and, as a practical matter, received the disclaimer within the nine-month period after his death, and (iii) her actions as executrix in administering the estate and transferring funds to the religious order were actions taken in a fiduciary capacity and did not constitute acceptance of the property interests or direction regarding disposition of the interests by the disclaimant. The Service rejected the arguments, stating that her vow of poverty made several years earlier is not a qualified disclaimer because it didn't satisfy the state law requirements for a valid disclaimer and was not a written refusal to accept the property interest passing from decedent and did not describe or designate the particular property being disclaimed. On this basis, the Service ruled that the residuary bequest did not qualify for the estate tax charitable deduction under Code Sec. 2055. Because the residuary estate passed to the nun under the terms of decedent's Will and the disclaimer was not timely made, the order received the residue pursuant to the nun's obligation under her vow of poverty and not from the estate.

Deduction Disallowed For IRA Distributions

In TAM 200444021, among the assets included in decedent's estate were certain IRAs. After the payment of all debts and expenses, decedent's estate did not contain sufficient cash to pay the estate tax. Distributions from the IRAs were made to the estate to obtain the necessary cash to pay the estate taxes. The estate reported the distributions as income in respect of a decedent under Code Sec. 691(a) on the estate's income tax return, claming a deduction under Code Sec. 691(c) for estate taxes attributable to the IRA distributions. The Code Sec. 691(c) deduction claimed was less than the amount of income taxes paid by the estate for the income reported with respect to the IRA distributions. The estate deducted the amount of income taxes paid that exceeded the Code Sec. 691(c) deduction on decedent's estate tax return, taking the position that this amount was either: (i) a claim against decedent's estate; or (ii) an administrative expense of selling property of the estate in order to pay the estate taxes under Code Sec. 2053(a).

The National Office disallowed the deduction, ruling that the income taxes paid by the estate may not be deducted on the decedent's estate tax return as claims against the estate because Code Sec. 2053(c)(1)(B) disallows a deduction under Code Sec. 2053(a) for income taxes paid on income received after the death of the decedent. Citing Regs. §20.2053-6(a), the National Office further ruled that the only taxes which may be deducted as administrative expenses are excise taxes. The National Office noted that Congress recognized the problem of income tax inherent in certain assets included in a decedent's gross estate and determined that the proper relief is to allow an income tax deduction under 691(c) to the estate

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or beneficiary reporting the income. The estate has availed itself of this deduction and that any additional benefit beyond what Congress intended would be unwarranted.

Charitable Deductions Not Defeated By Retained Management Control Over Donated Property

In PLR 200445023 and PLR 200445024, an individual and an LLC each proposed to donate cash and securities to a university (tax-exempt under Code Secs. 170(b)(1)(A)(ii), 501(c)(3), and 2522(a)) under separate identical agreements that called for the contributions to be placed in a brokerage account that would be managed by the donors. Under each agreement, any donations to the university will be unconditional and irrevocable and are to be placed in an investment or brokerage account, established in the name of the university exclusively for its benefit. The donors will surrender all rights to retain or reclaim ownership, possession or a beneficial interest in any donation, and are prohibited from diverting the assets held in the account to any person. Under each agreement, the donor, or her or its investment manager, may manage the investments in the account under a limited power of attorney but may not engage in any act of self-dealing with respect to assets in the account.

Among the investment restrictions and limitations on management of the account: (i) investments may be made only in U.S. equities, U.S. open-end mutual funds, U.S. closed-end mutual funds, U.S. fixed income securities (including, but not limited to treasuries and mortgage-backed, asset-backed and high-yield securities), offshore/onshore hedge funds, REITS, and private placements; (ii) no investments may be made in companies in which either donor owns, directly or indirectly, more than 5% of the outstanding shares of stock; (iii) assets in the account may not be pledged or encumbered by a donor (or her or its advisor), or used to satisfy any of their debts or liabilities; (iv) neither donor may vote any stock or other securities held in the account; (v) assets in the account may not be commingled with either donor's assets outside the account; (vi) the power to manage investments terminates 10 years from the date of the donation; and (vii) no investments may be made in short sales, forward settling transactions, derivatives, or any borrowings.

The university has the right at any time or for any purpose and in its sole discretion to withdraw any or all of the assets held in the account or to terminate the limited power of attorney and the agreement. In addition, the agreement will terminate automatically in severe loss cases, as determined by the university in its sole discretion, and may be terminated at any time by either party upon written notice to the other party.

The Service concluded that the retention of investment management control by donors, subject to the restrictions and limitations contained in the agreements, is not substantial enough to affect the deductibility of the property contributed, and does not constitute the retention of a prohibited partial interest under Code Sec. 170(f)(3). Therefore donors may deduct their contributions of the cash and publicly traded securities to the university for income tax purposes.

The Service further concluded that the retained power to manage investments is not the retention of an interest in the property for purposes of Code Sec. 2522(c)(2) and Reg §25.2522(c)-3(c)(1). The retained power does not cause the gifts to be subject to a condition or power under Reg §25.2522(c)-3(b). Accordingly, a gift tax deduction will be allowable under Code Sec. 2522.

Estate Can Deduct Interest On Loan Also Benefiting QTIP Trust

In PLR 200449031, decedent established a revocable trust during his life and executed a Will directing the residue of his estate (other than certain closely held stock) to this trust. Decedent's wife, who predeceased him, directed under her Will that her shares of closely held stock pass to the revocable trust, along with other assets she owned. Decedent was given a qualifying income interest in the trust and wife's executor made a QTIP election under Code Sec. 2056(b)(7) with respect to the assets that passed from her to the trust.

Decedent's estate included his closely held stock, other closely held business interests owned by him and, under Code Sec. 2044, the portion of the revocable trust that constituted QTIP. Because it appeared that a sizeable portion of the estate consisted of closely held interests, the executors and trustees determined that it would not be a prudent exercise of their fiduciary duties to sell the stock or the underlying assets of the closely held corporation. The executors liquidated a substantial portion of the estate's non-closely held business assets to pay a portion of the estate tax liability and then determined that it was in the best interest of the corporation to secure a commercial loan with a bank to pay the balance of the estate tax liability.

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The estate requested a ruling that the interest attributable to the loan obtained from the bank is deductible as an administration expense under Code Sec. 2053(a)(2), which provides that the value of the taxable estate is determined by deducting from the value of the gross estate such amounts for administration expenses as are allowable by the laws of the jurisdiction under which the estate is being administered. Under Reg. §20.2053-3(a), amounts deductible from a decedent's gross estate as "administration expenses" are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it.

Observing that the estate and revocable trust (including the QTIP share) are the co-borrowers for the full amount of the loan from the bank and that the estate will seek contribution from the QTIP trust for its portion of the deferred estate taxes as directed in the trust instrument and required by law, the Service concluded that the interest attributable to the loan obtained from the bank to pay the estate's federal and state estate tax liability is deductible as an administration expense under Code Sec. 2053(a)(2), if it is determined that the loan was necessary for the administration of the estate. The ruling expressed no opinion on whether or to what extent the loan was necessary for the administration of the estate.

Right Of Recovery Against QTIP Property

In PLR 200452010, decedent's husband created a revocable trust providing that upon his death, a portion of the trust assets were to be distributed to a marital trust for the decedent's benefit. Upon decedent's death, the trustee was directed to divide the balance of the trust estate into equal shares for the husband's then living children from a prior marriage. Following husband's death, a state court approved the division of the marital trust in accordance with the provisions of Code Sec. 2652(a)(3) and as a result, the marital trust was divided into two separate QTIP trusts, one GST-Exempt and one GST Non-Exempt. Husband's estate made an election under Code Sec. 2056(b)(7) with respect to the property held as part of the QTIP Trusts.

Decedent's Will contained a broad tax clause directing that all estate, inheritance, succession, death or similar taxes (except generation-skipping transfer taxes) assessed with respect to all property or interests in property included in her estate for such tax purposes be paid out of her residuary estate and were not to be charged to or against any recipient or beneficiary. The trustee of the QTIP Trusts stated his intention not to reimburse the estate for the estate taxes attributable to the inclusion of the QTIP Trusts in decedent's gross estate, claiming that under decedent's Will, she waived the estate's right of recovery under Code Sec. 2207A.

The Service ruled that decedent's Will did not waive the estate's right of recovery under Code Sec. 2207A, and therfore, once the federal estate tax on decedent's estate has been paid, decedent's estate would be entitled to recover from the trustee of the QTIP Trusts the amount of federal estate tax (including penalties and interest) attributable to the QTIP Trusts. Decedent's will did not contain any specific language indicating an intent to waive the estate's right of recovery under Code Sec. 2207A(a)(1) and therefore the Service concluded that the broad tax clause in decedent's Will did not constitute a waiver by decedent of her estate's right to recover the amount of federal estate taxes attributable to the QTIP Trusts.

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ETHICS COLUMN

By PAUL C. HEINTZ
OBERMAYER, REBMANN, MAXWELL & HIPPEL, LLP

An acquaintance corners a lawyer at a cocktail party and asks how much the lawyer would charge to prepare a Will for him. The lawyer obtains some information about the family, gives him a probable range of fees and arranges to see him the following week. The lawyer's conflict check within the firm reveals why the wife of the acquaintance did not participate in the conversation: The lawyer's partner, a domestic relations lawyer, advises that he has just been formally retained by her to bring a divorce action against the acquaintance. What does the lawyer do?

Until recently, the Pennsylvania Rules of Professional Conduct did not specify what duties lawyers may have regarding a prospective client. However, a number of opinions issued by both the Philadelphia Bar Association's Professional Guidance Committee and its Pennsylvania Bar Association counterpart acknowledged that such duties existed.

That changed on January 6, 2005 when the Pennsylvania Supreme Court adopted the Rule 1.18, entitled "Duties to Prospective Clients." The Rule, "effective immediately", provides that it "shall govern matters thereafter commenced and, insofar as just and practicable, matters then pending." The new rule is both clear and practical.

The Rule makes it clear that the cocktail party conversation turned the acquaintance into a "prospective client" because the lawyer discussed with the acquaintance "the possibility of forming a client-lawyer relationship."

Obviously, the lawyer's first step in this case is to make certain that the representation goes no further. Accordingly, the lawyer must inform the prospective client that the lawyer cannot represent him. The facts determine whether he should give the reasons for declining the representation. If he finds from his colleague that divorce discussions had already begun and that the acquaintance was already represented in the divorce matter, the lawyer might even advise the prospective client that the pending divorce action precludes the representation. On the other hand, if the divorce action would come as a surprise to him, the lawyer, obviously, should not specify the basis for declining the representation.

The next question is what effect, if any, the contact might have on the ability of the colleague to continue the representation of the wife in the divorce action. Sometimes, that "prospective client" who attempts to initiate a lawyer-client relationship, or begins to give the lawyer significant information, has an intent to disqualify the lawyer and his firm from representing the other party. It may be possible that the intent to disqualify motivated the cocktail party conversation. If so, and if it were clear there was an intent to disqualify the firm and the colleague from representing the wife, the acquaintance is not entitled to the protections of Rule 1.18.

If the contact was innocent, the lawyer must determine whether the information received during the brief cocktail party conversation was deemed to be "disqualifying information." Disqualifying information is defined as that which "could be significantly harmful to that person" if revealed, in this case, to the divorce lawyer in the firm. If the lawyer only learned the names, addresses, and ages of the family members during the conversation and nothing more, that would hardly be called "disqualifying information." The lawyer's declining to represent the acquaintance would end the matter.

If the lawyer spent more time – and in the interest of cementing the lawyer-client relationship, lawyers often do this - to obtain detailed and significant asset information, it could well be that he acquired "disqualifying information." If he obtained "disqualifying information", there are two ways the divorce case can be saved for the firm. First, the lawyer could obtain the informed consent of both the husband and wife to allow the firm to continue to represent the wife in the divorce action. Second, if obtaining that consent is impossible or impractical, he has a second, more complicated option. If he determined that he took reasonable measures to avoid exposure to more disqualifying information than was reasonably necessary to determine whether to represent the acquaintance, he can then

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Ethics Column, continued

save the case for the firm by agreeing to be screened from any participation in the matter whatsoever and to refrain from obtaining any portion of the fee resulting from the divorce case. He must still provide written notice promptly to the prospective client of the lawyer's intentions.

Regardless of the outcome of the analysis, the lawyer would be prohibited by Rule 1.18(b) from using or revealing significantly harmful information, except as permitted by Rule 1.9, pertaining to former clients, even if he or the prospective client decided not to proceed with the representation. That duty exists no matter how brief the initial contact turned out to be.

Of interest, the new Rule provides that imputation of the knowledge to others in the firm pursuant to Rule 1.10 may be avoided if the lawyer follows the three steps set forth above. If he took reasonable measures to avoid exposure to more disqualifying information than was reasonably necessary to determine whether to represent the prospective client, if all disqualified lawyers within the firm can be timely screened and kept from participating in the fee and if written notice is promptly given to the prospective client, the firm may retain the divorce case. Rule 1.0(k) sets forth the appropriate screening procedures.

Perhaps the most important lesson to be learned from Rule 1.18 is the importance of obtaining as little information as possible from the prospective client before the lawyer completes the firm's internal conflicts check. It can take much tact and self-discipline, particularly in the midst of the excitement of developing a new lawyer-client relationship, to minimize the conversation and to delay for a number of days, until after the conflict check, reviving that contact. Unfortunately, though, the larger the firm, the more likely that tact and self-discipline will have to be exercised during the first contact with a prospective client.

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NOTICE

The Executive Committee of the Probate Section has approved the formation of two new Subcommittees, one on Closely Held Business Interests, chaired by Karin Kinney (215-979-3846, kkinney@mccarter.com), and one on Orphans' Court Litigation and Dispute Resolution, chaired by Laurence Norford (215-972-8417, lnorford@saul.com). Anyone interested in either subcommittee should contact them.

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