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Report of the Chair

By KATHLEEN A. STEPHENSON
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Each year, my church celebrates the life of Martin Luther King, Jr. This year, Dr. King's "Letter from Birmingham Jail" was read during the Sunday service. In the letter, Dr. King explained to other religious leaders why he believed he needed to challenge the status quo noting the extent and impact of the virulent racial prejudice that existed in our country at that time. What struck me, however, was Dr. King's challenge to those religious leaders. Why were they not with him in the Birmingham jail? Why were they not ready to stand up? Why were they not ready to act?

I have reflected on Dr. King's questions and have tried to answer them within the context of providing pro bono legal services. There are many – way too many – people in Philadelphia who do not have access to legal services and suffer as a result. Our status as attorneys places us in the privileged situation of being able to address this pressing need.

At the March quarterly meeting, Judge Lazarus reported on the need for attorneys to represent alleged incapacitated persons in connection with guardianship proceedings. These proceedings address fundamental constitutional rights and our court is often confronted with the need to ensure that persons in such situations are represented by independent counsel. I can speak from personal experience that these pro bono representations are rewarding and, usually, not onerous or time consuming. If this is something you are willing to do, simply write Judge Joseph D. O'Keefe, Court of Common Pleas, Orphans' Court Division, Room 300, City Hall, Philadelphia, PA 19107.

At future quarterly meetings, you will hear from other providers of pro bono services and will be given the opportunity to volunteer to help an indigent client. The range of legal services needed run the gamut from "tangled title" cases, to landlord/tenant issues to, of course, preparation of wills, powers of attorney and living wills. Any attorney who takes on a pro bono client always has the full support of the pro bono organizations who interview prospective clients and, often, provide free training. In addition, thanks to the efforts of the Association's Public Interest Section, area law

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Inside this Issue...

Delaware Asset Protection Trusts

By DANIEL F. LINDLEY
PRESIDENT, THE NORTHERN TRUST COMPANY OF DELAWARE

Over the years, many investors and their advisors have come to find that the state of Delaware is a trust-friendly jurisdiction that promotes modern laws and attractive income tax advantages. This article highlights the domestic asset protection trust, which provides significant benefits for nonresidents, and their professional advisors, who may be considering whether to establish a trust in Delaware.

DELAWARE ASSET PROTECTION TRUSTS SHIELD A CLIENT'S ASSETS FROM CREDITORS

Apart from growing wealth, effective estate planning should include strategies for preserving and shielding assets from creditors' claims. As one such strategy, Delaware law allows individuals to create "self-settled" trusts that offer asset protection benefits for people who require additional protection for personal financial assets. A Delaware asset protection trust presents an alternative for individuals who do not want to take on the expense, complexity and tax compliance obligations of offshore trusts to protect their assets. With its passage in 1997 of the Qualified Dispositions in Trust Act (QDTA), Delaware became the second state to enact legislation allowing domestic asset protection trusts (the other states currently permitting such trusts are Alaska, Rhode Island, Nevada, Utah, Oklahoma, South Dakota and Missouri).

"The QDTA allows domestic asset protection trusts where an individual can create and be beneficiary of an irrevocable trust while retaining various interests in, and powers over, the trust"

The QDTA allows an individual (grantor) to create an irrevocable trust of which he or she is a beneficiary while retaining various interests in, and powers over, the trust. Despite the grantor's continuing interest in potential distributions of income and principal from the trust, his or her creditors will not be able to reach the assets of the trust to satisfy their claims unless they can establish quickly and convincingly (during a "tail period") that the funding of the trust amounted to a fraudulent transfer.

POPULARITY OF ASSET PROTECTION TRUSTS IS INCREASING

In recent years there has been a dramatic increase in the frequency with which people have established asset protection trusts. Their surge in popularity has been driven: partly by the crisis in the availability of medical malpractice insurance largely by ever-larger jury verdicts in injury claims and new theories of tort liability.

"Asset protection trusts serve a variety of well-intentioned people who seek to safeguard a portion of their net worth against unforeseen and uninsured claims against their wealth"

Asset protection trusts are set up for a variety of reasons.

Not surprisingly, a substantial number of grantors of asset protection trusts are physicians, who are using the trusts to protect a portion of their wealth against excess, uninsured liabilities. Corporate directors who have concerns about their personal liability for uninsured claims arising out of shareholder litigation are also benefiting from asset protection trusts. Examples of asset protection trusts also range well beyond the obvious candidates: elderly individuals who have lost their excess liability "umbrella" insurance policies due to their advanced age want to continue driving their cars with reduced liability coverage, and are therefore using asset protection trusts for continued protection from liability; an asset protection trust can be a substitute for a prenuptial agreement, protects the pre-marital estate of an individual without the awkwardness that accompanies the

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Report of the Chair, continued

schools have students ready and willing to assist. Simply, click on the "Pro Bono Assistance" icon on the Philadelphia Bar Association's web site.

Dr. King was proud to be an extremist for the cause of civil rights in this country. Pro bono legal services benefit all of society not just the immediate client and I challenge this Section to be extremists on this issue. Listen to Dr. King! Be willing to act!

Delaware Asset Protection Trusts, continued

request for, and negotiations over, a prenuptial agreement; young adults establish asset protection trusts at the insistence of their parents, who prefer making gifts into a vehicle that is secure against future creditor and spousal claims, and that discourages wasteful spending; individuals use asset protection trusts to avoid state income taxes on substantial capital gains, when avoidance of grantor trust treatment, not asset protection, is the person's primary motive; asset protection trusts are used to make completed gifts to descendants, often in the form of perpetual "dynasty" trusts while retaining the ability to access trust assets in the event of dire financial crisis or disability.

THE TAIL PERIOD FOR CREDITOR CLAIMS IS GENERALLY FOUR YEARS

Once the assets are transferred to a Delaware trustee, the QDTA begins a "tail period" during which a grantor's creditors have the right to have their claims satisfied from the assets of the trust, but only if a creditor can prove by clear and convincing evidence that the grantor's transfer was fraudulent.

Spouses and children and personal injury claimants are exempt from the tail period.

The QDTA establishes two classes of "creditors" who are not subject to the tail period and who do not have to prove that the transfer to the trust was fraudulent. These are spouses and children and personal injury claimants. A spouse or child with a claim of unpaid alimony, child support or a share of marital property can claim trust assets irrespective of the time or the circumstances under which the transfer to the trust occurred. If a grantor transfers his or her assets to a trust before marriage, the grantor's future spouse cannot rely on the spousal exemption and the trust will serve as a substitute for a prenuptial agreement. A person with a claim for death, personal injury or property damage that predates a transfer to a Delaware trust may satisfy their claim out of trust assets if the grantor is held responsible for the negligent acts or omissions.

AN ASSET PROTECTION TRUST IS NOT FUNDAMENTALLY DIFFERENT FROM OTHER ESTATE PLANNING TRANSACTIONS

The intent of the QDTA is to strike a reasonable balance between the rights of a grantor to protect his or her assets and the rights of creditors – both existing and future – to reach the trust assets. With a substantial tail period (commonly 4 years) for future creditors and outright exemptions for spouses and people with pre-existing personal injury claims, we do not believe that creditors are unfairly disadvantaged in their efforts to lay claim to trust assets. Although the concept of an asset protection trust may conjure up pejorative associations, an asset protection trust that does not involve any fraudulent transfers is not fundamentally different from a number of other estate planning transactions in which the grantor retains an interest and obtains protection against claims of his or her creditors. Qualified retirement plans, individual retirement accounts, cash value life insurance policies and personal homesteads in Florida and Texas all permit a grantor to shelter assets from creditor claims while enjoying and having total control over how the assets are disposed. An asset protection trust is one more arrow in the estate planner's quiver for ensuring the security of a client's assets.

A more detailed "white paper" on this subject written by Mr. Lindley can be obtained by emailing him at dfl1@ntrs.com.

Daniel F. Lindley is principal author of Delaware legislation repealing the Rule Against Perpetuities and permitting self-settled asset protection trusts.

FAMILY TIES

By G. SCOTT BUDGE, Ph. D.

If the 1980s and 1990s can be called the decades of the entrepreneur, the new century promises to be the era of the family business. Fascination with the lone-riding entrepreneur seems to have given way to concern with life after the start-up years, a life often marked by the day-to-day presence of family members in the business.

Including family in business is far from unusual. According to a Small Business Administration study, 90 percent of all American businesses are family-run. (Some researchers have set the number as high as 95 percent.) They contribute close to 55 percent of the GNP and employ 50 million people. Furthermore, they are not only "small businesses," but comprise between 30-35 percent of Fortune 500 companies. The New York Times, S. C. Johnson, Campbell Soup, and Adolph Coors are among the many well-known family businesses.

The View From Outside. In spite of their numbers, images of the family businesses are mixed. Some, like the Rockefellers or Carnegies, are virtual icons of free enterprise. Others feel family business equals nepotism and endless conflict. When business is good, the family's capabilities are praised, even idealized. When it's bad, family problems are often believed to be the cause. One need only refer to TV's *Dallas, Falcon Crest*, or *Dynasty* or, in more recent times, *Arrested Development,* to see how dramatic and engaging such conflicting images can be.

Among business owners themselves, the images can be quite ambivalent. A recent survey by *Inc.* magazine of its pick of the 500 fastest-growing companies showed that 73 percent of CEOs do not think of their companies as being family businesses, even though 44 percent have relatives working for them. Still, it is one thing to downplay the external perception of being a family firm and another to avoid dealing internally with the reality of being such an organization.

Trouble can arise when not wanting to be viewed as a family business translates into not wanting to face the complexities it introduces. Successful family businesses are candid with themselves about what they are up against, and turn negatives into positives.

Facing Family Conflict – Now. Conflict in families is not only normal but necessary for certain kinds of development through the lifespan. Difficulties encountered by family firms often arise when the family avoids conflict and allows it to fester.

One family-business situation in Chicago had so deteriorated that members were gradually reduced to talking to each other through lawyers. In another scenario, a daughter who built a career as a gifted businesswoman was forced out of the running for CEO in the eleventh hour because of concerns that a woman would not be accepted by major customers. In Los Angeles, three brothers silently avoided each other because of tensions that emerged following the introduction of spouses into their mail-order business.

Successful families avert these possibilities by providing opportunities for conflict resolution and policy-making. Regular family meetings are held, as are retreats that have either a business or a family focus. Separate governance structures, one for the family and one for the business, may be used to link both, via family councils composed of elected members who mediate family and business interests. The Telemedia Corporation, a Canadian media concern held by the de Gaspe Beaubien family, employs such a model.

Less-sophisticated systems are the rule, but the same principles apply. Forums are created to air conflicts and make decisions consonant with family and business values. The family builds confidence, shares a vision, and works to address each member's interests. One family business council decided to pay an unproductive in-law a salary to *stay out of the business!* Because it was decided jointly and with a plan, rather than impulsively and unilaterally, it is working for everyone.

Including Outsiders. Whether – and how – to involve family in the business is attended by the need for intelligent choices about integrating nonfamily participants. According to one survey, fewer than 20 percent of family companies have nonfamily members on their board of directors. Yet virtually all of those companies said letting outsiders on the board was one of the best decisions they ever made. It boils down to the philosophy and culture of the firm: Is it an open system or closed? Is it able to integrate others or not?

This is an important matter. It indicates the extent to which high-quality nonfamily managers and employees will be attracted and retained,

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Family Ties, continued

which itself is one measure of a firm's ability to integrate changing customer and market information.

Successful family firms start from within by reviewing the treatment, compensation, and motivation of nonfamily participants. What makes the strongest employees stay? How can strong managers be rewarded even though they may never be able to compete with "junior" for the top slot?

Reviewing these issues internally prepares the family for considering the question of outside representation on the board as well as professionalization of family and nonfamily management.

Passing the Torch. The challenges of succession are among the greatest a family in business faces. Because of general aging trends, many business owners are busy developing exit strategies. Yet only 30 percent of family businesses make it to the second generation; ten percent to the third.

The owner, whose life has been devoted to the business, must consider divesting ego resources from the business for the first time in his or her adult life. It is a time of crisis and opportunity, where a new self comes into play.

Successful transitions are engineered by parents who build a new future for themselves as well as their children. For some, this means starting a charitable foundation. For others, like New York City-based Kenneth Preston, former owner of a multinational physical-therapy products company, it means consulting to other family companies and teaching university classes. The choices are many, but they require taking time for oneself away from the business to sort out priorities and face the future.

Paradoxically, parents must *lead while allowing themselves to be relieved of leadership*.

Ambivalence about turning away from the business is often fierce – and extends throughout the family as children protest parental control, but often secretly fear the responsibility that a transfer of power entails. Importantly, in the strongest family firms, this is seen as a necessary condition for change, not its impediment.

If there is more than one possible successor, the owner's struggles will be aggravated by sibling infighting. The dual roles of chief executive and parent complicate decision-making. As a chief executive, choice of successor may be relatively straightforward. As a parent, it means choosing one child over another. This only serves to intensify parental ambivalence, which is often temporarily resolved by a reassertion of parental control and avoidance of the succession issue.

Outsiders often see all this as a matter of indecision and have a difficult time being sympathetic. After all, their careers hang in the balance, too. They want to be helpful and stay out of the middle but feel compelled to look out for themselves. What if the owner dies? If this brother is chosen over that one? If they sell the business to avoid ongoing family strife? There is a clear need at these times for family and nonfamily participants to be sensitized and sympathetic to one another's concerns.

Preparing and developing successors cannot begin early enough. Successfully families often lay solid ground for confident and capable successors by having children work outside the family business first. When they enter the business, credibility with nonfamily employees is gained by having them enter at the level of their experience and competence, not inheritance. Promotion is based on merit rather then entitlement. Successive challenges, such as running a district office and then a regional office, serve as objective proving grounds for children.

Preparing for Wealth Transfer. Transfer of power is often complicated by the technical problems accompanying the transfer of wealth. Yet, according to Gary B. Schreiner, a Lake Success, New York-based estate-planning attorney, the technical solutions to wealth transfer are less complex than most believe. Shareholder agreements enable owners to create incentive-based ownership plans which preserve the owner's wealth while laying the groundwork for family or nonfamily succession. Estate-tax snafus, usually a function of liquidity problems created because the business typically accounts for the bulk of the estate, are manageable through insurance products that interact with shareholder agreements.

The real problem, says Schreiner, is the planning necessary for successful transitions: "Most of my clients who get serious about planning are 70 years old. By that time, the cost of this kind of planning is very high compared with the benefits it provides." It's an emotional issue, one younger owners have a hard time facing. "You can tell someone lack of estate planning is costing him two million bucks," he comments, "and they still don't do it."

Roderick W. Correll, former family business owner and executive director of the Family Firm Institute in Johnstown, New York, agrees. Many struggles between his brothers and sisters could have been avoided,

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The Use of Formulas to Establish Value

By FREDERICK C. BERTSCH III, MBA, ASA
PRESIDENT, F.C. BERTSCH & COMPANY, INC.

One sometimes sees agreements among owners of private companies which require the company and/or the surviving owners to purchase the stock of a deceased owner. The motive behind the agreements is to provide liquidity to the estate of the deceased and to assure continuity of the business and its ownership structure.

A key feature of such agreements is the price at which the deceased's interest must be purchased. The two options in this respect are to have the price determined by an appraiser or to use a formula approach.

Formula approaches are preferred by some because they produce a quick answer and avoid the cost of an appraisal. Formulas usually involve some multiple of earnings or sales over a stated period of time or are a function of the company's net worth. Other factors can be considered: some years ago we worked with a formula where officers' compensation and distributions to the deceased were the determinants.

The downside of formulas is that they can produce an unintended windfall for one of the parties offset, of course, by a detriment to the other. The reason for this is that formulas look to the past while value is a function of what is expected in the future. In some situations the past does provide a reasonable basis for future expectations, but exceptions are easy to find.

Consider that many private companies produce no interim financial statements or take little care in their preparation. Once a year the outside accountant comes in and assists in the preparation of rigorous statements. As a result, buy/sell formulas often point to the "last full year(s) data", or, "the most recent year end." This means there is likely to be a time gap, perhaps of many months, between the price determination date and the age of the data used in the determination. The following are some examples of where this time gap might lead to inequities.

1. Subsequent to the valuation data, the company is granted a new patent which opens up substantial new markets (note that prior period results may have been depressed by development costs);

2. Subsequent to the valuation data, the company loses a major customer, a key supplier, or a key employee;

3. Subsequent to the valuation data, risk-oriented capital markets crater, causing a decline in the value of equity interests generally;

4. A cyclical company, after three years of record profits (which provide the valuation data) has a backlog of one half the prior year's level and apparently is entering a steep decline (e.g., residential housing in recent times);

5. Subsequent to the valuation data, the company is accused of illegal acts with far reaching consequences.

In each of these cases the risks or rewards of equity ownership could be borne by the party(s) obligated to purchase the deceased's interest, but the price paid would be out of balance with value received.

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Family Ties, continued

"if Dad would have told us what he wanted to do." If addressed and communicated in advance, parents' wishes for their children and business are less likely to be undermined by unanticipated legal and tax complications.

The solution is to look into estate issues early, and do it "a little bit at a time," according to Schreiner.

In all, family businesses are part of the heart and soul of the American business community. Against negative stereotypes and tough competition, many survive and prosper, bringing stability and satisfaction to far more than just the family. Internal and external strengths in family businesses can be harnessed when the owning family is willing to give and take, plan for future contingencies, and take a close look at themselves as businesspeople and family members.

There's no one right way to manage family and business concerns. But the lessons already learned need to be well employed for family businesses to remain important resources to the national economy.

G. Scott Budge, Ph.D., is a Philadelphia-based consultant specializing in work with family firms.

Warming up to HEETs

By JPMORGAN PRIVATE BANK

In discussing long-range, intergenerational planning with clients, funding the health and educational expenses of future loved ones frequently emerges as a top priority. This is especially true in light of the upward spiral of health and education costs.

Over the last 25 years, medical expenses have grown at a pace more than two percentage points higher than the rate of inflation, while college costs have increased roughly twice as fast. (See table on page 8.)

Finding a tax-efficient way to provide for these costs for generations to come is not easy, given U.S. state and federal gift, estate and generation-skipping-transfer (GST) tax laws. However, one type of trust for this purpose – the Health and Education Exclusion Trust (HEET) – first popularized in a 2000 Trusts and Estates article,[1] has attracted increasing attention from planners.

Under the right circumstances, a HEET can allow clients who are philanthropic and also concerned with the health and educational needs of future generations to satisfy both objectives. HEETs may be particularly appropriate for clients who have already fully utilized their GST tax exemption or who expect to do so in the future. However, HEETs are not quite as simple as they might first appear. To take maximum advantage of these vehicles requires an awareness of a few key drafting challenges as well as sophisticated planning and thoughtful administration.

What exactly is a HEET?

A HEET is a trust designed, in part, to pay the medical and tuition expenses of an individual's grandchildren and more remote descendants in perpetuity until the corpus of the trust is exhausted. Section 2503(e) of the Internal Revenue Code excludes direct payments of tuition and medical expenses by grandparents "on behalf of" a grandchild (or great-grandchild) from both GST and gift taxes. A trustee can transfer property from a trust directly to a school or medical provider on behalf of a grandchild (or more remote descendant) of the donor to cover tuition or medical expenses without the transfer being subject to GST tax.[2]

A key feature of a HEET is that at least one beneficiary must be a "non-skip person" (as defined below) because of GST tax issues. Since a charity is a non-skip person, it can be incorporated as a beneficiary of the HEET to absorb a significantly meaningful interest in the trust. By vesting a charity with a substantial present economic interest, the trust should avoid taxable transfers either upon creation or at the time of any subsequent distribution.

Here's why: The GST tax was initially set up as a backstop to the federal gift and estate tax regime. Generally, a GST tax applies to lifetime gifts or testamentary bequests, whether made outright or in trust, for the benefit of "skip persons." Skip persons include donees or heirs receiving property who are at least two generations younger than the donor (e.g., grandchildren). If all of a trust's beneficiaries are skip persons, the trust itself will be treated as a skip person.

[1] Roy M. Adams, David Handler and Deborah Dunn, "A New Twist on Sec. 2503(e): Health and Education Exclusion Trust (HEET)," Trusts and Estates (July 2000).

[2] IRC §2642(c)(3).

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The Use of Formulas, continued

I would add a word of caution to those choosing the appraisal (as opposed to formula) route. Certain terms, such as "fair market value," have very specific meanings to appraisers and have potential for resulting in unintended consequences (e.g., low values through the application of lack of control and lack of marketability discounts). Therefore, care must be exercised in spelling out just how the appraiser is to do his/her job.

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Frederick C. "Chuck" Bertsch, III has been valuing business interests for 30 years. He belongs to the American Society of Appraisers (where he is an Accredited Senior Appraiser) and the Philadelphia, Delaware County and Chester County Estate Planning Councils. He has served as CFO of two companies (one NYSE listed) and is a graduate of Wharton (MBA in Finance) and Wesleyan University. His valuation practice focuses on ownership interests in closely-held businesses, partnerships, and limited liability companies. He may be reached at 610-964-1800, fcb@fcbertsch.com or *fcbertsch@fast.net*.

Medical and education costs have far outpaced the rate of inflation	
Average annual percentage change 1980-2005	
U.S. Consumer Price Index	3.5%
Medical care costs	6.0%
Tuition at four-year private colleges	7.3%
Tuition at four-year public colleges	8.0%

Source: Department of Labor, Bureau of Labor Statistics; College Board, Trends in College Pricing, 2005

"A taxable termination" generally occurs when the interests of the individual beneficiaries in the oldest (non-skip-person) generation end and only skip-person beneficiaries hold interests in the trust. Naming a charity as a beneficiary, however, ensures that there will always be a non-skip-person beneficiary of the trust. In essence, as long as a charity holds a significantly meaningful interest in the HEET, there is an argument that there can be no taxable termination of the trust for GST tax purposes. Creation of a valid HEET assumes that a charity is a legitimate, bona fide beneficiary of the trust.

HEETs may be incorporated into a testamentary plan and funded with after-estate-tax dollars. Or a HEET may be created during lifetime, although funding will generally require a taxable gift. Many practitioners assert, however, that it should be possible to minimize adverse gift tax consequences by funding the HEET with the remainder available upon expiration of either a grantor retained annuity trust (GRAT) or charitable lead annuity trust (CLAT).

For example, the donor of the GRAT or CLAT might authorize its trustee, at the trust's expiration, to allocate some portion of the remainder to a HEET.[3] Alternatively, a donor might consider funding an irrevocable life insurance trust (ILIT) drafted to be administered as a HEET by the trustee following the donor's death.

What constitutes a meaningful interest?

One of the most vexing questions regarding a HEET is how significant the charitable interest must be for the IRS to respect the charity as a bona fide perpetual "non-skip-person" beneficiary of the trust. Practitioners must be prepared to convince the IRS that charity's interest in the HEET is not so transitory or de minimis that it should be ignored and that this interest, even if substantial, does not have as its primary purpose the avoidance of GST tax.

Some practitioners believe a 10% unitrust amount must be paid annually to charity in order to confirm that it is a bona fide perpetual non-skip-person beneficiary of a HEET. However, such a large annual payout to charity runs a real risk that the trust property will be significantly diminished by the time the donor's grandchildren and great-grandchildren become the primary current trust beneficiaries. (See box on page 9.) Others offer up the rationale that a 4% - 6% annual unitrust amount is meaningful and cannot be ignored as transitory or de minimis.

The test to determine whether the charity's interest will be respected is subjective under the controlling law because it depends at least in part on the grantor's intent in creating the charitable interest. So the more meaningful the charity's aggregate economic interests in the trust, the greater the likelihood that it will be found acceptable.

[3] Such an allocation could also be designated to other types of trusts including a GST exempt dynasty trust or a traditional non-exempt children's trust.

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The implications of a large annual payout to charity

	Trust without significant Charitable interest	Trust with 10 unitrust payout to charity
Initial funding	$5,000,000	$5,000,000
10% unitrust distributed to charity (years 1-30)	–	$10,321,513
Income expended for health and education (years 20-30)	$520,000	$550,000
Income expended for charity	$30,000	–
Trust corpus in year 30	$26,618,420	$1,457,121

Assumptions: Effective gift rate tax = 46%; effective transfer tax rate (at terminations) = 55%; effective income tax rate today = 35%; effective capital gains tax rate today = 15%; total expected pre-tax return = 8.2%; expected volatility = 10.5%; capital appreciation = 6%; yield = 2.3%. Cash flows are nominal. Actual effective tax rates may be higher or lower depending upon specific circumstances. Tax rates subject to change. Assumptions may not reflect current market conditions. Actual results may be expected to vary from assumptions, which are made for discussion purposes only. Source: JPMorgan

Several practitioners have postulated that funding a HEET with the remainder interest in a charitable lead trust (CLT) creates a favorable fact pattern. The present value of the charitable interest at the CLT's creation may be as much as 100% of the funded value. That interest, coupled with a present unitrust interest of, say, 5% – a percentage interest which has variously been legally determined to be substantial or significant for other tax purposes – successfully precludes any argument that the charity's interest is not significant or that charitable intent was not a significant purpose in the trust's creation.[4]

[4] For other contexts in which a current vested economic interest amounting to 5% or more of the underlying value has been deemed substantial or significant, see: IRC §4942, IRC §664, IRC §2041(b)(2) and IRC §147.

While there are some practitioners who believe a mandatory annual distribution as a percentage of trust income should suffice, others would counter that there is no authority for such position. The latter would contend that the donor is susceptible to an argument that charity's interest may be de minimis especially if the trust is invested for growth not income.

Until the IRS offers guidance on the minimum amount that must be distributed to charity each year to confirm that the charity is a bona fide perpetual "non-skip-person" beneficiary of the trust, uncertainty will persist. Obviously, there are significant practical implications resulting from the size of the charitable interest. The example below compares the results of a HEET distributing 10% annually to charity with a trust that does not have the same charitable interest.

A HEET with too significant a charitable interest risks depletion over time whereas an insignificant charitable interest creates the economic characteristics of a dynasty trust that builds value over time but may not be respected for tax purposes.

Unlike a qualified charitable remainder trust (CRT) or charitable lead trust (CLT), there is no up-front income or gift-tax charitable deduction available when an individual establishes an inter vivos HEET. At best, as mentioned above, amounts distributed by a grantor HEET to charity should entitle the donor to a charitable contribution deduction on a year-by-year basis. Also unlike a testamentary CRT or a CLT, no estate tax charitable deduction is available when a HEET is funded by an estate.

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HEETS, continued

Design and drafting considerations

Determining the proper allocation to charity is not the only issue confronting practitioners drafting a HEET; there are also a number of other important considerations to bear in mind.

• *Grantor versus non-grantor trust.* An inter vivos HEET can be structured as a grantor or a non-grantor trust. A grantor trust might provide a benefit to beneficiaries, since the growth of the trust's corpus would not be limited by income tax.

A non-grantor trust, on the other hand, could also provide a tax benefit since the charitable distributions would likely reduce the trust's income tax liability. And if, as in the example above, the trust's annual charitable distributions equaled or exceeded the trust's total realized return, the trust corpus would not be affected by income taxes. Finally, unlike an individual, who is subject to charitable deduction AGI limitations, a trust can deduct a charitable contribution of up to 100% of trust income.

At the same time, however, a non-grantor trust may inadvertently create problems for non-charitable beneficiaries. With respect to all HEETs structured as separate taxpayers for federal income tax purposes, the distribution of any trust distributable net income (DNI) on behalf of a beneficiary-grandchild's tuition or medical care expenses may result in taxable income to such grandchild. Where does the grandchild come up with the money to pay such income tax? Any trust distributions made directly to a grandchild to cover their income tax liability will be subject to GST tax. To avoid such a result, the HEET should be drafted to encourage the trustee to use DNI first to pay charity and then, to the extent possible, use trust principal to pay a beneficiary's tuition and medical care expenses.

• *Nature of the charitable interest.* The tax and distribution decisions are not the only concerns that a practitioner drafting a HEET needs to consider. Another is whether the "separate share" rule, under which substantially separate shares may be treated as separate trusts for each beneficiary, applies.

In order to apply the separate share rule, the separate share must exist "from and at all times after creation of the trust" and must be considered definite throughout the term of the trust. To blunt the separate share rule concern, the draftsperson might initially provide the charity with an "indefinite" interest (e.g., minimum required annual distributions, with the trustee possessing discretion to distribute larger amounts to charity) until the death of the surviving child of the donor. Under these circumstances, it should be difficult to apply the separate share trust rules to charity's interest in the HEET because its interest is "indefinite" from year to year prior to the death of the last non-skip-person individual beneficiary.

Finally, the naming of one or several charities – either specifically or generally – as remaindermen upon termination due to the death of the last lineal descendant further insures the charitable intent of the parties and the ultimate distribution of all interests in a tax-effective manner. This can be done by invoking the appropriate law in the trust.

• *Authorized distributions for educational and medical purposes.* The trust instrument could perhaps include a precatory request – but no direction – by the donor that the trustee not make any distributions from the trust to or for the benefit of any children or skip persons except for direct transfers to educational organizations or medical providers. The instrument could qualify this request by noting that other distributions might be allowable only if the trustee is satisfied that a skip person's future health and educational expenses will be met.

The trust instrument should identify those distributions that are considered qualified transfers for education or health care. The trustee could be encouraged to make distributions on behalf of skip-person beneficiaries to pay tuition by making payment directly to an educational organization that maintains a regular faculty and has both a regularly enrolled body of students and an established curriculum. The trustee should be discouraged from making a direct payment for any other educational expense, such as books or room and board fees, as these are not qualified transfers.

The other types of qualified transfers under a HEET are trust distributions made for the medical care of the trust beneficiaries; these are defined under the same rules that apply to the income tax medical expense deduction. Accordingly, qualified transfers for medical care should include medical and long-term care insurance premiums which are within the definition of the medical expense definition for income tax purposes. Over-the-counter medications and cosmetic surgery would not be eligible transfers.

In addition, criteria will need to be established for determining which members of future generations should be eligible for distributions. Without such criteria, the possibility of diminishing a trust with broad discretionary authority is high. A workable framework could

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include: need, achievement, participation in community service, and a process for “applying” for distributions. The drafter should also focus on the class of descendants to be included. For instance, should step-children be given the same consideration as direct lineal descendants?

• *Selection of trust situs*. When preparing the trust instrument, it’s important to consider the choice of the governing state law under which the trust will be interpreted and administered. Since one of the donor’s objectives in establishing the trust is to provide benefits to grandchildren and possibly more remote (and as yet unborn) descendants, establishing the trust in Delaware or some other state that authorizes perpetual trusts should be explored. Moreover, Delaware does not impose an income tax on accumulated trust income of a non-grantor trust without source income in another state unless a Delaware resident is a beneficiary. (Please note: Each donor must consult with his or her own tax advisors about the appropriate choice of law for the trust to confirm that, even if one jurisdiction is selected for the governing law of the trust, another state’s tax law will not apply to the trust by virtue of either the domicile of the trustee or donor, or the location of the trust assets.)

• *Trust protectors*. The practitioner drafting a trust designed to operate as a HEET should consider use of a “trust protector.” Many long-term dynasty trusts require flexibility in the preparation of the trust instrument. Despite the best efforts of the draftsperson, not every possible future event can be predicted. Accordingly, the use of a trust protector is most appropriate in long-term trusts.

The trust protector ensures that the trustee will be responsive to the needs of remote or unborn descendants. The trust protector could be given veto power over certain discretionary powers of the trustee, including the power to amend the trust instrument, the power to add, remove or revise beneficial interests in the trust, and the power to change the trust situs. Perhaps the trust protector can be authorized to modify how assets are distributed from the trust to ensure that the trust fulfills the donor’s original intentions. Remember, however, that in most situations the trust protector is a fiduciary who has a duty of responsibility to the trustee and the trust beneficiaries.

Conclusion

HEETs can offer a useful way to provide for future generations’ educational and health care needs in a tax-efficient way. But constructing a HEET that achieves the desired family and tax objectives involves considerable care and planning.

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An Estate Planning Glossary

By BLANCHE LARK CHRISTERSON
DEUTSCHE BANK

Annual Exclusion Gifts – refers to the $12,000 you can give gift tax-free to as many people as you want, every year. The gift does not reduce your $1 million lifetime gift tax exclusion, and can be $24,000 per year if your spouse agrees (a "split gift").

Annuity – a fixed amount that is typically payable to you for a period of years, your lifetime, or a combination of the two. While an annuity offers you the certainty of a steady payment, it is not considered a hedge against inflation.

Applicable Credit Amount – formerly referred to as the "unified credit." This credit applies against Federal estate tax, and in 2007 and 2008, it shelters property worth $2 million; in 2009, it will shelter property worth $3.5 million. In 2010, the estate tax disappears for the year, and by 2011, it reappears. At that time, the applicable credit amount will drop to its pre-2001 Tax Act level of $345,800, and will only shelter property worth $1 million.

Applicable Exclusion Amount – the amount of property you can shelter from estate tax because of the Applicable Credit Amount (see above).

Ascertainable Standard – this refers to a clearly discernable standard by which a trustee is allowed to pay out income or principal to a trust beneficiary. A typical ascertainable standard permits distributions for a beneficiary's "health, education, maintenance and support." Such standards are particularly important when a trustee has a "beneficial interest" in the trust – i.e., is eligible for principal or income distributions – and will help ensure that the trust property won't be taxable in the trustee/beneficiary's estate.

Charitable Deduction – the deduction against income, estate and gift taxes for gifts to charity. There are limitations on the charitable income tax deduction, but no limitations on the charitable estate or gift tax deduction.

Charitable Gift Annuity – an annuity that you receive from a charity in exchange for a gift to that charity (the annuity also can be payable to someone of your choosing). If you contribute cash for the annuity, your annuity payments are treated as part ordinary income and part return of your investment; if you contribute appreciated property, your gift is treated as a "bargain sale," so that your annuity payments are treated as part ordinary income, part long-term capital gain (assuming you owned the asset for more than a year) and part return of your investment. If you outlive your life expectancy and are still receiving payments, they will be treated as ordinary income. When you make your charitable contribution, the present value of charity's remainder interest is eligible for a charitable income tax deduction. Typically, the rates a charity will pay are lower than commercial rates, and are generally based on recommendations from the American Council on Charitable Gift Annuities. A charitable gift annuity can be a good way to benefit charity and retain an income stream.

Charitable Lead Trust (CLT) – a "split-interest" trust that is the inverse of a charitable remainder trust (see below). With a CLT, charity gets the "up-front" income interest, generally for a period of years, and your heirs get the remainder interest, or what's left over after the income interest ends. You generally don't get an income tax deduction for the charitable interest, although you do get a gift or estate tax deduction for it (that deduction offsets the gift of the remainder interest). As with the CRT, the income interest must be either an annuity (a fixed amount that remains the same regardless of the trust's value) or a unitrust interest (a variable amount that goes up or down depending on the trust's value). Unlike the CRT, there is no minimum required percentage for the annuity or unitrust payout. A CLAT is a charitable lead annuity trust and a CLUT is a charitable lead unitrust.

Charitable Remainder Trust (CRT) – a "split-interest" trust that is the inverse of a charitable lead trust (see above). With a CRT, the "up-front" income interest goes to an individual for a period of years (no more than 20) or life, and the "remainder interest" (what's left over after the income interest ends) goes to charity. The income interest is a taxable gift if it is payable to someone other than you or your spouse. The charitable remainder interest is not subject to estate or gift tax, and is eligible for a charitable income tax deduction (subject to limitations) if you set up the trust during your life. Lifetime CRTs can be an effective way to diversify low basis assets while deferring capital gains tax. Because the trust is tax-exempt, it sells the assets tax-free and has 100% of the proceeds available to generate income for you. Although you are taxable on the trust's payout, it likely will be

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subject to favorable capital gains tax rates if the trust is invested for growth. The payout must be either an annuity (a fixed amount that remains the same regardless of the trust's value) or a unitrust interest (a variable amount that goes up or down depending on the trust's value). With a CRAT (an annuity trust), the payout must equal at least 5% of the trust's initial value, but no more than 50% of that value; with a CRUT (a unitrust), the payout must equal at least 5% of the trust's annual value, but no more than 50% of that value. The present value of the charitable remainder must equal at least 10% of the trust's initial value. There are several variations on a CRUT, including a "FLIP-CRUT." With this, the trust initially pays the lesser of its income or at least 5% of its annual value, and on a specified date or an occurrence that's outside of your control (such as marriage, divorce or the birth of a child), the trust becomes a regular CRUT. The FLIP-CRUT can therefore offer tax deferred savings and potentially serve as an additional retirement account.

Community Property – the property ownership system that applies in nine states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. (Alaska has an elective community property system.) With community property, you and your spouse are each deemed to own one-half of the property. When the first of you dies, the cost basis of all of your community property is adjusted to its fair market value. Assuming the property has appreciated, this basis "step-up" wipes out all of the property's built-in capital gains. This is more favorable than how jointly held spousal property is generally treated in the rest of the United States. In those jurisdictions, when the first spouse dies, only one-half of the jointly held property gets a basis adjustment, so that only one-half of the built-in capital gains disappear.

Credit Shelter Amount – refers to the amount you can shelter from estate tax. Through 2008, this amount is $2 million. With proper planning, a husband and wife collectively can shelter $4 million from estate tax through 2008 ($7 million in 2009, or $3.5 million each). See Applicable Exclusion Amount, above, and Credit Shelter Trust, below.

Credit Shelter Trust – a trust that is typically created under your will and is funded with the amount you can protect from estate tax (see Applicable Exclusion Amount, above). A credit shelter trust is usually for your surviving spouse and children, and can pass tax-free to your children at your spouse's death. It thus shelters the trust property from estate tax in both your and your spouse's estates.

Crummey Power – refers to a trust beneficiary's limited right (usually for 30 days) to withdraw property that is added to a trust. The power is designed to ensure that your gift to the trust qualifies for the annual exclusion by giving the beneficiary a "present interest" in the gift (i.e., the right to withdraw it). If the trust does not have Crummey powers, your gift to it will erode part of your $1 million lifetime gift tax exclusion. Crummey powers are typically used in irrevocable life insurance trusts. ("Crummey" was the name of the taxpayer whose court case gave rise to this technique; see Annual Exclusion Gifts, above.)

Decoupling – refers to what a number of states (over 20) have done to preserve their state death tax credit revenues. In other words, decoupled states have untied themselves from the federal system so that they can continue to receive state death tax dollars that otherwise disappeared completely in 2005. The effect of living in a decoupled state such as New York, New Jersey, Illinois or Massachusetts, is that your estate taxes are higher.

Donor-Advised Fund – refers to a charitable fund that is typically run by a community trust or a financial institution. Your contribution to the fund goes in a separate account, and is eligible for an upfront income tax deduction even though the dollars may not be paid to charity until a later date. The funds grow tax-free, and you may recommend how your charitable donations are used. Because the fund is treated as a public charity, your gifts are not subject to the restrictive charitable income tax limits imposed on gifts to a private foundation. A donor-advised fund can be an attractive way to make directed charitable gifts without the complications of a private foundation (see below).

Dynasty Trust – a trust that is created in one of several jurisdictions that has abolished the "rule against perpetuities" (see below). A dynasty trust could theoretically last "forever" and need not terminate when the law usually requires trusts to terminate – generally about 100 years after they are created. Such trusts are typically set up in Delaware or South Dakota.

Estate Tax – a tax on the transfer of property at death. If your taxable estate plus your adjusted taxable gifts (post-1976 lifetime gifts that erode your $1 million gift tax exclusion and are not includible in your estate) exceed the applicable exclusion amount (see above), then your estate will be subject to estate tax. The 2001 Tax Act repealed the estate tax in 2010, but just for that one year. Prior to that one year of repeal, the amount you can protect from estate tax has been increasing, and the top estate tax

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rate has been decreasing: from 2007 through 2009, it is 45%. Assuming the estate tax returns in 2011, the top rate again will be 55%.

Estate Tax Exclusion – the amount of property you can protect from estate tax (see Applicable Exclusion Amount, above).

Executor – the individual, bank or trust company named in your will to administer your assets at your death and to see that the terms of your will are carried out (the bank or trust company is called a "corporate" executor). The executor's duties include figuring out what you owned, gathering your assets, determining your debts and liabilities, and filing your estate tax return and final income tax return. The executor also must make a number of post-mortem tax planning decisions and preserve your estate's assets before they are distributed. This can mean managing those assets, making sure they are appropriately insured and securing insurance if they are not.

Family Limited Partnership (FLP) – a pass-through entity that is used to hold assets and create valuation discounts for gifts of limited partnership interests ("pass-through" means that the partnership's income passes through to the partners, and is not separately taxed to the partnership). Valuation discounts are generally available for gifts of limited partnership interests because the rights and powers of limited partners are restricted: e.g., the limited partners cannot transfer their interest, participate in the management of the underlying partnership assets, access the underlying property, control partnership distributions or easily withdraw from the partnership. FLPs (along with limited liability companies, which have been similarly used) are under much scrutiny from the IRS. Judging by recent cases, an FLP is more likely to survive that scrutiny if there is a "legitimate non-tax purpose" behind it, and it is funded with some kind of working business, rather than just marketable securities.

Fiduciary – one who stands in a relationship of trust to others, and often, holds people's assets. Executors and trustees, for example, are fiduciaries. A bank or trust company is a "corporate" fiduciary. As then-Judge Benjamin Cardozo described the fiduciary's standard of behavior in a 1928 New York Court of Appeals case (Meinhard v. Salmon), it requires "[n]ot honesty alone, but the punctilio of an honor the most sensitive."

529 Plan – a tax-preferred account that allows you to save for your child's higher education. All 50 states offer them, and there are many variations within the plans. The following website is a springboard for accessing all the different plans: http://www.collegesavings.org/.

Generation-Skipping Transfer Tax (GST) – a transfer tax that is in addition to the estate or gift tax. Its rate is generally equal to the highest estate tax rate (45% through 2009); the tax applies (in 2007 and 2008) to transfers over $2 million to people such as grandchildren, regardless of whether the transfer is outright or in trust. In 2009, the GST applies to transfers over $3.5 million. In 2010, the tax is repealed, but is scheduled to come back the following year, when it will apply to generation-skipping transfers over $1 million, indexed for inflation. The purpose of the GST is to make sure that tax is collected when property passes from generation to generation.

Gift Tax – a tax on lifetime transfers of property that exceed $1 million in the aggregate. Its top tax rate is the same as the top estate tax rate (45% through 2009). In 2010, when the estate tax is repealed, the gift tax remains, and will have a top rate of 35%. In 2011, that top rate tax is scheduled to go back to 55%.

Grantor – you are a grantor if you establish a trust while you're alive. Another term for this is "settlor" or "trustor."

Grantor Retained Annuity Trust (GRAT) – a trust that transfers future appreciation to your heirs. Typically, you fund a GRAT with property that is likely to appreciate significantly or is a "cash cow." With the GRAT, you receive an annuity for a period of time, generally two to three years. At the end of that period, whatever is left in the GRAT (the "remainder interest") passes either outright or in further trust to the heirs you've named in the trust. You are deemed to make a gift when you fund the GRAT, but because the present value of your right to receive the annuity is worth something, the value of that gift is reduced. It is possible to structure a GRAT to make your annuity equal 100% of what you put into the trust so that there is no gift (a "zeroed-out GRAT"). Assuming the GRAT outperforms the interest rate used to value your annuity (see the 7520 Rate, below), that "excess" will pass tax-free to your heirs.

Grantor Trust – a trust you create while you're alive, and of which you are the owner for income tax purposes. In other words, you report the trust's income, deductions and credits as part of your income tax, and don't treat the trust as a separate taxpayer. A "defective" grantor trust is deliberately structured to be taxable to you for income tax purposes, but is not includible in your estate for estate tax purposes. The advantage of such a trust is that your payment of the

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trust's income taxes is a tax-free gift to the trust and its beneficiaries, since neither will have to pay any tax on the trust's realized income.

Gross Estate – refers to everything you own at death, including your individually owned property, your share of jointly held property, pension plans, insurance benefits, etc. Determining the size of your gross estate is the first step in determining your potential estate tax liability.

Health Care Proxy – the document in which you name an individual to be your "health care agent" or "health care surrogate." This individual will make health care decisions for you when you no longer can. The rules regarding health care proxies vary from state to state. See Living Will, below.

Incentive trust – refers to a trust that is typically created under your Will, and that is designed to encourage your beneficiaries in certain types of behavior, such as achieving high grades, gainful employment, etc. Such a trust might permit principal distributions to the beneficiary, for example, that are equal to the beneficiary's wage income. Although well-meaning, incentive trusts can inadvertently penalize beneficiaries: e.g., children who choose low-paying professions or stay home to raise a family won't get as much as the child who becomes an investment banker – probably not what you had in mind.

Income Beneficiary – the individual or entity currently eligible to receive income from a trust. Depending on the type of trust, the trustee may be required to pay out the income, or may have discretion to do so. An individual's income interest, for example, typically ends at death.

Inheritance Tax – a tax that some states impose at your death. Contrary to an estate tax, which is imposed on property passing at your death, an inheritance tax is imposed based on the recipient of the property: in general, the closer the degree of kinship, the lower the tax.

In Terrorem Clause – refers to a clause in a will (or trust) that threatens to deprive you of your inheritance if you challenge the document giving you the inheritance. Courts are generally reluctant to enforce "no-contest" clauses and construe statutes authorizing them very narrowly. In some jurisdictions, such as Florida, these clauses are unenforceable.

Irrevocable Life Insurance Trust (ILIT) – an irrevocable trust that you set up during your lifetime to hold insurance on your life. The purpose of the trust is to remove the insurance from your taxable estate and that of your spouse, if you're married. Typically, your surviving spouse and children are the beneficiaries, and at your spouse's death, the trust passes estate tax-free to your children. Insurance trusts generally use "Crummey powers" (see above) to secure the annual exclusion for gifts to the trust that are intended to pay the insurance premiums. If you fund the trust with an existing policy, you must live for three years after setting up the trust to keep the insurance out of your estate; if your trustee buys the policy on your life, the three-year survivorship rule does not apply.

"Kiddie Tax" – an income tax rule that applies to children under the age of 18. It requires that their "unearned income" in excess of $1,700 (the 2007 threshold) be taxed at their parents' highest rate. (Unearned income refers to items such as interest, dividends and capital gains.) Custodial accounts under the Uniform Transfers to Minors Act, for example, are subject to the kiddie tax (see UTMA/UGMA accounts, below).

Living Will – a document that sets forth your health care wishes when you no longer can. The document can request, for example, that you not be kept in a "persistent vegetative state," or it can also request that every measure be taken to keep you alive (in general, the law presumes that you would want to be kept alive; the living will usually rebuts that presumption). Most states recognize living wills, which are often coupled with a "health care proxy" (see above).

Marital Deduction – the deduction against estate or gift taxes that applies when you make gifts to your spouse. The gifts can be outright or in trust. The marital deduction postpones estate tax until your surviving spouse dies. It is unlimited if your spouse is a U.S. citizen, and subject to restrictions if your spouse is not a U.S. citizen (see QDOT, below).

Minor's Trust – a trust that holds property for a minor (let's say it's your child), and is sometimes referred to as a "2503(c) trust." It is a receptacle for annual exclusion gifts, and does not require Crummey notices (see Crummey Powers, above). The trust must be solely for your child, and can be used for your child's benefit before he reaches age 21, when it must be turned over to him. Some trusts, however, are structured to give the child a "window of opportunity" to terminate the trust at age 21, and continue on if the child doesn't seize the opportunity.

Per Capita – "by the head." Trust documents occasionally provide that when the income beneficiary dies (i.e., the individual who's currently eligible to receive trust income), the remaining trust property will pass to the individual's "surviving issue,

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per capita and not per stirpes." This means that all of the income beneficiary's surviving descendants take an equal share of what's left of the trust. To illustrate, assume that Mom is an income beneficiary, and has three children, each of whom has two children. At her death, the property passes to her surviving issue, per capita and not per stirpes. Because Mom has nine surviving descendants (three children and six grandchildren), each one receives 1/9 of the trust remainder. The more usual distribution, however, is per stirpes (see below).

Per Stirpes – by the "stocks" or "by the roots." Trust documents often provide that when the income beneficiary dies (i.e., the individual who's currently eligible to receive trust income), the remaining trust property will pass to the individual's "surviving issue, per stirpes." This means, for example, that grandchildren split whatever share their deceased parent would have received. To illustrate, assume that Mom is an income beneficiary, and has three children, each of whom has two children. Mom's son predeceases her. At Mom's death, the property passes to her surviving issue, per stirpes. Her two living children will each take 1/3, and her predeceased son's two children will each take 1/6 (i.e., they split their father's 1/3 share). Contrast this disposition with "per capita" (see above).

Power of Appointment – your right to direct who takes trust property, either when you're alive or at your death. A "general power of appointment" (GPA) means that in addition to directing the property to other people, you also can direct it to yourself, your estate, your creditors or the creditors of your estate. The property over which you have a GPA is includible in your estate for estate tax purposes. A "limited power of appointment" (LPA) means that you cannot give the property to yourself, your estate, your creditors or the creditors of your estate – even though, depending on how broadly the power is written, you could conceivably give it to anyone else. The property over which you have an LPA is not includible in your estate for estate tax purposes.

Power of Attorney – a document wherein you name an individual to act as your "attorney-in-fact" and transact business on your behalf. Note that the attorney-in-fact is not authorized, for example, to make annual exclusion gifts (see above) unless the document so states. A "durable" power of attorney is effective when executed and remains so even when you become incompetent. A "springing" power of attorney does not become effective until a stated event occurs, such as your incompetence. Any power of attorney ends at your death, when your attorney-in-fact can no longer act on your or your estate's behalf.

Present Value – this refers to what a future dollar (or revenue stream) is worth in today's dollars. For example, in a GRAT (see above), the present value of your annuity stream is subtracted from the value of the property you transfer to the GRAT to determine the value of your gift to your heirs (they get what's left over). In other words, if the present value of your annuity is 100%, the present value of the remainder gift is zero. The 7520 rate (see below) is the interest rate used to make this computation.

Private Foundation – a charitable entity that you can create either as a trust or a corporation, and that can last in perpetuity. It gives you maximum control over your charitable giving, and lets you direct how the foundation uses its contributions. Private foundations have a number of rules that must be scrupulously followed, such as minimum amounts that must be paid out annually and prohibitions on self-dealing. The income tax deduction for lifetime contributions to private foundations is subject to a number of limitations, whereas the gift and estate tax deduction for such contributions is unlimited (e.g., if you contribute to a private foundation under your will, that gift is fully deductible).

Probate Estate – assets that you own in your own name that are governed by your will, and not by contract or state law. In other words, the probate estate includes things like real estate held in your own name, bank and brokerage accounts and tangible personal property. It does not include, for example, life insurance, jointly held property and qualified plan benefits and IRAs.

Required minimum distribution – refers to the minimum amount you must start taking from a qualified plan, such as a 401(k) or a pension or profit sharing plan, when you retire or reach age 70 ½, whichever happens later. With IRAs, however, you must start taking these distributions when you reach age 70 ½, regardless of whether you are still working.

Right of election – refers to your surviving spouse's right to "elect against" your will. If your spouse makes the election, he or she will receive the portion of your estate to which state law entitles surviving spouses. This "elective share" is in lieu of the provisions you made for your spouse in your will.

QDOT – a "qualified domestic trust." This trust qualifies for the marital deduction and is used to postpone estate tax when the decedent's surviving spouse is not a U.S. citizen. It can be structured as 1) a QTIP trust (see below), where the surviving spouse

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receives all of the trust's income; 2) a "general power of appointment" trust, where the surviving spouse receives all of the trust's income and can direct what happens to the property at his or her death; 3) a charitable remainder trust, where the surviving spouse is the only income beneficiary; or 4) an "estate trust," where trust income accumulates and the trust pours into the surviving spouse's estate at his or her death. A QDOT is onerous in that principal distributions to the surviving spouse (unless they are "hardship" related), will trigger estate tax – or what would have been taxable at the first spouse's death on the principal distributions had the trust not been in existence. The QDOT is thus a "pay as you go" tax regime, contrasted with the QTIP trust, which is a "pay once you're gone" tax regime.

QTIP Trust – a "qualified terminable interest property" trust. This trust qualifies for the marital deduction and therefore postpones estate tax. Your surviving spouse must receive all of the trust's income at least annually, and may receive, if you wish, principal distributions at the trustee's discretion. When your spouse dies, the trust is taxable in your spouse's estate. After taxes, the property passes as you provided under the terms of the trust. QTIP trusts are especially useful in second marriages, where you want to provide for your surviving spouse but ensure that the children from your first marriage receive any remaining trust property when your spouse dies.

Qualified Personal Residence Trust (QPRT) – a trust to which you transfer a "personal residence" (i.e., a principal residence or a vacation home) and retain the right to use the residence for a term of years. At the end of the trust term, the residence goes to your heirs. Although you are deemed to make a gift when you transfer the residence to the trust, that gift is reduced by the present value of your right to use the residence and direct what happens to it if you die during the trust term. No matter how much the residence appreciates by the time your heirs receive it, it won't be subject to gift tax. For the QPRT to be successful, you must outlive the trust term.

Qualified Plan – refers to various retirement vehicles, including pension, profit sharing plans and 401(k) plans; it also loosely refers to IRAs (individual retirement accounts).

Remainderman – the individual or entity (such as a trust) that takes whatever is left in a trust when the income beneficiary's interest is over (see income beneficiary above).

Revocable Trust – a trust that you can revoke or amend at any time. A revocable trust – also known as a "living trust" – offers no transfer tax savings, but serves as an asset management vehicle during your life, and can help provide for you if you become disabled or incompetent. At your death, it serves as a will substitute and governs the disposition of assets you transferred to it during your life and at your death (usually through a "pour-over" will).

Rule Against Perpetuities – the general rule that a trust must terminate within "lives in being" plus 21 years. In other words, unless the jurisdiction that governs the trust has abolished its rule against perpetuities (see "dynasty trust" above), a trust generally must terminate 21 years after the death of the last beneficiary who was alive when the trust was created. The theory behind the rule is that property interests should not be tied up forever. A trust that lasts for the perpetuities period often runs for about 100 years.

Sale to a Defective Grantor Trust – like the GRAT (see above), this technique is a play on potential appreciation. It involves selling an asset to a trust in exchange for a note that is usually interest-only (i.e., a balloon note). Because of the trust's structure, neither gain from the sale nor interest on the note is taxable to you. Any appreciation in excess of the note's interest rate goes to the trust, and ultimately your heirs, gift-tax free. If you die while the note is outstanding, there is uncertainty as to the income tax consequences of the transaction.

Second-to-die/Survivorship Life Insurance – a cost-effective insurance policy on two people's lives that does not pay out until the death of both insureds. It is frequently used to insure husbands and wives, and can help replenish the wealth lost to estate taxes at the surviving spouse's death. It is also used as a source of cash for paying the estate tax of an illiquid estate. Typically, second-to-die insurance policies on husbands and wives are placed in irrevocable life insurance trusts (see above) to ensure that the policies will not be subject to estate tax in either spouse's estate.

7520 Rate – an interest rate that the IRS publishes monthly. It is an assumed rate of return, and is used to determine the present value of things like annuities, life estates, and income and remainder interests ("7520" refers to the section of the Internal Revenue Code that defines this rate). For example, you use the 7520 rate to determine the present value of your annuity in a GRAT, and the present value of your retained interests in a QPRT. The 7520 rate is sometimes referred to as the "hurdle rate"; the more your property outperforms it, the better the result (i.e., more property is removed from your estate).

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From the Orphans' Court

By BERNICE J. KOPLIN
SCHACHTEL, GERSTLEY, LEVINE & KOPLIN, P.C.

The lengthy Adjudication by Judge John W. Herron in *Mary and Emanuel Rosenfeld Foundation Trust*, O.C. No. 1664 IV of 2002 (dated July 31, 2006) is remarkable. It addresses interesting issues, among which are the surcharge and removal of trustees, and the reimbursement of the attorneys fees thereby generated. It was made available on the website of the First Judicial District but is not reported elsewhere, thus has the status of a slip opinion. It does not constitute precedent, the facts are unusual, and it is being appealed. Nevertheless, "the case involved novel theories and formidable advocates" (Adjudication at 69) and it is instructive how some of those issues were resolved in this Adjudication.

The Background: The original Pep Boys were Emanuel "Manny" Rosenfeld, Maurice "Moe" Strauss, Moe Radavitz and Graham "Jack" Jackson, four industrious young Philadelphians who pooled $200 each in 1921 to establish an auto parts supply company that would become an industry leader. By the early 1930s, Pep Boys had grown to 40 stores in Philadelphia, and in 1933 The Pep Boys - Manny, Moe & Jack became a west-coast chain. Pep Boys' primary mission from its inception was to build the finest retail aftermarket chain in the automotive supplies market. Pep Boys one-stop shopping format evolved into accessories, hard parts, tires, and service, and eventually into the automotive parts supermart. In 1946, Pep Boys went public. "Manny" Rosenfeld became the company's first corporate president, a position he held until his death in 1959. He and other founding Pep Boys held control until 1986, when the first non-founder became president. Despite its characterization as "volatile," the company's stock grew significantly in value throughout its history, but peaked on June 20, 1997.

The Foundation: The perpetual charitable trust which "Manny" Rosenfeld created on December 1,

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Estate Planning Glossary, continued

Stepped-up Basis – the upward adjustment in basis that occurs when you die owning appreciated assets (if the assets have depreciated, you get a "step-down" in basis). In other words, when you die, because your assets are generally valued as of your death, this value serves as the new cost basis. The effect of this is to wipe out any built-in capital gains, so that if your heirs cash in their inheritance, they won't pay capital gains tax (assuming the asset hasn't appreciated between your death and when it's sold). Note that when the estate tax disappears in 2010, so does the basis step-up: instead, there will be "carryover basis" (subject to a few exceptions) – meaning that your heirs inherit your cost basis and pay capital gains tax when they cash in their (appreciated) inheritance. Carryover basis means that you need to keep careful records of all capital improvements and dividend reinvestments: if your heirs can't prove your basis, the likely presumption is that it's zero.

Transfer Tax – the tax on the transfer of property. Estate, gift and generation-skipping transfer taxes are all transfer taxes.

Trust – an entity where the trustee holds legal title to the assets, and the beneficiaries (the people who benefit from the trust) hold beneficial title to the assets. A trust can help save people from themselves, potentially insulate assets from creditors and offer tax savings.

Trustee – the individual or bank or trust company named to administer a trust's assets. The trustee's duties include managing the trust's assets, making appropriate distributions to beneficiaries and filing the necessary tax returns for the trust. When a bank or trust company fills that role, it is called a "corporate" trustee.

UTMA/UGMA accounts – refers to "custodial" accounts under the Uniform Transfers to Minors Act and the Uniform Gifts to Minors Act (UTMA is an updated version of UGMA). Both Acts provide a simple framework for transferring property to minors: in general, UTMA lets you give a broader class of assets than UGMA and holds those assets until the minor reaches age 21 (unless you select age 18 when you set up the account); UGMA usually requires the minor to receive the property at age 18, unless you select age 21. More states are adopting UTMA.

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From the Orphans' Court, continued

1952, was the focus of the dispute. In accordance with its three-page governing instrument, the trust, a private foundation for federal income tax purposes, had four equal co-trustees. Initially it was Manny's two children, Lester and Rita, and his brother, Murray, who served with Wachovia Bank (successor to Fidelity-Philadelphia Trust Company). Since the governing instrument required that there always be three individual trustees to serve with the corporate trustee, Lester Rosenfeld's son Robert Rosenfeld had succeeded his uncle Murray at his death in 1979. Decisions were to be made by a majority of the trustees, being three of the four. The trust which at inception was funded with a total of 450 shares of Pep Boys stock worth $33,750.00 (in 1952-1953), grew in value to $19,520,203.00 on June 20, 1997 before falling to $15,094,625.00 on September 30, 1997 (the date of Wachovia's "clear beacon" letter) and plummeting to $2,420,766.00 on September 14, 2000 (Adjudication at 13-14). By the time of the Adjudication, the trust fund was worth approximately $8,303,453.80. P. 36 For the first forty-five years of this trust's administration, little or no consideration was given by any of the trustees to diversifying the trust holdings, which was almost entirely in Pep Boys stock, despite its volatility.

The Case: In the mid-nineties, when the industry became more competitive, Rita Stein and then Wachovia urged consideration of the advisability of retaining Pep Boys stock. Around June 1997 Wachovia attempted to schedule a meeting or conference call among all of the trustees to discuss diversifying the Foundation's assets, but without success (Tr. Exh. P-100, P-103). On September 30, 1997 Wachovia sent a three page letter warning the Rosenfelds that prudence required diversification. Deadlock resulted when the Rosenfelds refused to participate in the consideration process. The bank sent letters on October 22, 1998, March 17, 1999, and December 13, 1999. According to the Adjudication "In that March 17, 1999 letter, the bank emphasized that the Rosenfeld Foundation held only one asset, Pep Boys stock, which violated the "diversification rules as required by our Trust Compliance Officers. The bank therefore asked the trustees to sign the enclosed letter indemnifying the corporate trustee for loss of value. None of the trustees signed that indemnification letter" (Adjudication at 12). Wachovia's letter dated December 13, 1999 addressed to the Rosenfelds, "reiterated that 'it is clearly imprudent as trustees to hold only a single stock as the entire portfolio of the Foundation'." *Id.* Lester responded by letter dated December 21, 1999 stating that as an insider at Pep Boys he felt that to divest at his time and price was absolutely wrong, and that if Wachovia could not abide by this, then perhaps it should consider resigning as a trustee, and was sure that the other trustees would not object. *Id.* In late 2001 the trustees agreed to sell a substantial number of shares of Pep Boys as it reached appropriate prices, but then rejected every proposal from the bank as to reinvestment, so that 30% of the value of the trust was held in cash without the co-trustees being able to agree upon how to invest it (Adjudication at 16).

Procedural History: Wachovia did not proceed to court to break the deadlock which developed with the Rosenfelds. *See* P.E.F. Code §§3328, 7133; "When Trustees Are Deadlocked," *Fiduciary Review* (April 2005) p. 3. Rita Stein did not initiate her action until April 30, 2002, and then did so in a novel manner by filing against the other three co-trustees in the Civil Division, s*ee* P.E.F. Code §§711(21), 726; Pa. Rule 2156 of Judicial Administration. There she asserted claims for breach of fiduciary duty, negligence, unjust enrichment, surcharge, harm to her reputation for philanthropy, removal of defendant trustees, and partition of the Foundation. Although her father's governing instrument had suggested as potential donees a number of Philadelphia charities (predominantly of Jewish interest) she asserted that the precipitous decline in the fund's value and resulting decrease in distributable funds harmed her reputation by causing her to be unable to satisfy her pledges to charities in the area of Palm Beach, Florida where she resided. (Frequently the donees of a private foundation are determined annually thus preserving control in the philanthropic family, unlike a charitable remainder or lead trust where the donee generally is determined at the outset and cannot be changed). The defendants filed Preliminary Objections to the complaint in the Civil Division, the result of which was that in September 2002 the Civil Division transferred all of the counts except that for harm to reputation to the Orphans' Court Division. In September 2003, after discovery was completed in the Civil Division, the Rosenfelds and Wachovia were granted summary judgment dismissing the claim for harm to reputation.

When the case arrived in the Orphans' Court Division, Mrs. Stein's claims were ordered to be adjudicated in connection with the First Account of the Foundation which Wachovia had filed and to which Rita Stein had objected. In January 2004, Wachovia moved for summary judgment in the Orphans' Court Division and on May 19, 2004 all claims that sought relief against Wachovia were dismissed, *Rosenfeld Trust*, 25 Fid. Rep. 2d 165, 174-176 (O.C. Phila. 2004). *See,* "When Trustees are Deadlocked," *Fiduciary Review* (April 2005), p.

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3 - 4. The Court held that under the terms of the governing instrument, with three individual trustees and one corporate trustee, the corporate trustee could not be held liable for breach of fiduciary duty for failing to go to court to break a deadlock among the trustees as to diversification of assets where the trust agreement did not provide a method for breaking a deadlock. Further it held that although a corporate trustee may be held to a higher standard when it holds itself out as having expertise, the terms of this governing instrument established the standard of care. And it held that under the standard of care established by this governing instrument, where the corporate trustee urged the other trustees to diversify the trust assets, the corporate trustee could not be held liable for breach of fiduciary duty on the theory of failure to diversify. A motion for judgment on the pleadings by the Rosenfelds was denied, and the Orphans' Court permitted Rita Stein's claims of breach of fiduciary duty and negligence, seeking a surcharge and to partition the trust, to proceed against the Rosenfelds.

Appeal: Although the Court stated that "the attorneys achieved significant results for their clients within the complex nuance of facts presented: Rita Stein obtained a ruling that the Rosenfelds had breached their fiduciary duty; the Rosenfelds were able to limit the surcharge imposed for that breach; the bank obtained a summary judgment ruling in its favor on May 19, 2004" (Adjudication at 69), the Rosenfelds appealed the Adjudication dated July 31, 2006 which imposed a surcharge of $593,546.00 on the Rosenfelds, the Decree dated August 1, 2006 removing the Rosenfelds as Trustees, and the Decree dated August 14, 2006 granting Wachovia's petition for attorneys' fees in the amount of $425,506.54 (for services rendered April 2002 through June 2005) and taxing those fees against the Rosenfelds for their behavior which necessitated the litigation. On August 10, 2006 Mrs. Stein petitioned for her fees, in the amount of $314,167.00, also to be taxed against the Rosenfelds. The Court is holding this petition under advisement pending the exhaustion of appeals of the Decree signed August 1, 2006.

Removal and Surcharge: The Court removed and surcharged the Rosenfelds for their obdurate refusal to *consider* selling the company's stock, determining that participation in the "process" was required. The process in which the breaching co-trustees did not participate was described by the Court as "an actual and honest exercise of judgment predicated on a genuine consideration of existing conditions" (Adjudication at 35, *quoting Sky Trust*, 868 A. 2d 464, 492 (Pa. Super. 2005). Thus, the Court punished the Rosenfelds "obdurate refusal to work together to form a majority view on the advisability of selling Pep Boys stock in response to the September 30, 1997 letter of the bank" (Adjudication at 35), because they breached their duty in failing to rectify a fund overly concentrated with highly volatile stock once they were confronted on this issue by their co-trustees, (Adjudication at.42). The Court found that Lester Rosenfeld's conflict of interest, by serving as director of both Pep Boys and the Foundation, a violation thus: "Evidence at the hearing established that Lester Rosenfeld had "'invested his personal pride and good name as well as his personal capital' to such an extent in the Pep Boys Company that Lester crossed the line and breached his fiduciary duty to the charitable beneficiaries when he failed to respond to the bank's clear warnings about the need to diversify the trust in its September 1997 letter... and that his influence over his co-trustee Robert disrupted the process set up by the settlor for reaching a reasoned, majority decision as to the retention of foundation property" (Adjudication at 27-28). The Adjudication states that when the stock of Pep Boys was recovering, the Court implied that with agreement this matter would have been over, had there been agreement regarding the reinvestment of cash in the Foundation (Adjudication at 57-59). The Court also found that Lester Rosenfeld did not use insider information from which he should have known that Pep Boys stock was heading for a dramatic fall to Trust advantage, and that he personally had diversified or invested significantly in other companies (Adjudication at 9-10). The Court stated that it removed the Rosenfelds because "the welfare of the Foundation is endangered both the Rosenfelds' breach of fiduciary duty and by the total dysfunctional breakdown in communications among the individual trustees" (Adjudication at 60).

Loss: The Court confirmed that under Pennsylvania law an essential element of surcharge is proof of loss (Adjudication at 37). The Court rejected the analysis in *Estate of Pew*, 440 Pa. Super. 195, 655 A.2d 521 (1994)(trustees have no duty to diversify investments), which had concluded that there could be no surcharge where the accounting showed long term growth because in *Pew* the beneficiaries raised their objections at the end of an accounting period, not when the breach occurred, because the opportunity to change the disputed investment has dissipated (Adjudication at 37). The court further distinguished *Pew* by describing the dispute in the case at bar as "a dynamic struggle to change the course of investments to reap future benefits for the charitable beneficiaries." and stated that "The bank and Mrs. Stein,

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From the Orphans' Court, continued

in contrast, raised their objections contemporaneously and vigorously with their fellow co-trustees by September 1997" (Adjudication at 38).

Governing Instrument: The Court began its analysis with the governing instrument, determining that its language did not authorize "unfettered" retention of stock but that the co-trustees must do so prudently (Adjudication at 25), and that the document "contemplates majority action by the co-trustees, but provides no procedure for breaking the deadlock " (Adjudication at 24). By requiring 3 individual co-trustees with a corporate co-trustee it was clear to the Court that the corporate co-trustee was not left in charge by the Settlor.

Damages: The Court adopted the recognition in *Estate of Scharlach*, 809 A.2d 376, 384 (Pa. Super. 2002) and *In re Sky Trust*, 868 A.2d at 483 that damages for breach of fiduciary duty can be assessed based on unrealized gain (Adjudication at 41). *See* "Surcharge - Paper Loss," *Fiduciary Review* (March 2003), p.1 (discussing what the commentator believes to be the weakness of *Scharlach*). A significant portion of the Adjudication addresses the calculation of damages, to some extent because neither expert had illustrated Wachovia's suggestion made in its September 30, 1997 "clear beacon" letter. The Court stated that where investment decisions of trustees are challenged *contemporaneously* rather than *retrospectively* at time of accounting, damages should be calculated from the date of the alleged breach of fiduciary duty, in this case September 30, 1997, and calculated a damage award which under the unusual facts of this case, was probably the minimum that the Court could have awarded.

Reasonableness of Attorneys' Fees: The Court relied upon *Browarsky Estate*, 437 Pa. 282, 285, 263 A.2d 365, 366 (1970) for the proposition that a prevailing fiduciary is "entitled to an allowance out of the estate to pay for counsel fees and necessary expenses in defending himself against the attack." And it relied upon *Estate of Sonovick*, 373 Pa. Super. 396, 400, 541 A.2d, 376 (1988) and *Estate of Preston*, 385 Pa. Super. 48, 56, 560 A.2d 160, 164 (1989) for the propositions that the attorney requesting those fees has the burden of presenting facts to support the claim and its reasonableness (Adjudication at 68-69). The Court confirmed that "In determining the reasonable of attorneys' fees, Pennsylvania courts consider the facts according to the factors in *LaRocca Estate*, 431 Pa. 542, 246 A.2d 337, 339 (1968). Those factors are consistent with the factors provided by our Rules of Professional Conduct 1.5. *Accord*, (N.J.) R.P.C. 1.5(a); *Matter of Reisen*, *infra*. The Court applied the *LaRocca* factors to determine that the fees of the corporate trustee, in the amount of $425,506.54 were reasonable, including its characterization of the outcome for Wachovia of emerging "unscathed from its years of litigation over its conduct as a trustee," as a "significant achievement."

For a thoughtful and thorough article addressing the attorneys' fees *see* Glassman, "Substantial Attorneys' Fees Found to be Reasonable for Successfully Defending Bank Trustee Against Charges of Negligence and Breach of Fiduciary Duty Where Trustees Deadlocked Over Diversification of Charitable Foundation's Investments: Bank's Attorneys' Fees Not Assessed Against Foundation But Against Co-Trustees Due to Obdurate Breach of Their Fiduciary Duties Before Litigation Was Initiated," *ACTEC Journal* (Winter 2006) p. 372-373.

The Award of "Fees on Fees": Although "fees on fees" such as those awarded by the Court in its August 1, 2006 Order in this matter are not generally awarded, there appears to be no *per se* rule against fees on fees in our Commonwealth or elsewhere. By way of example, Pa. R.A.P. 2744 authorizes counsel fees as costs, including counsel fees "as may be just," to penalize a part for a frivolous appeal and to compensate his adversary for costs and delay in defending the frivolous appeal. According to our Commonwealth Court, Rule 2744 should be applied in such a way that the party awarded a fee as a result of a frivolous appeal should be "made whole" for all consequences of his adversary's frivolous conduct, *In Re Ciaffoni*, 136 Pa. Commw. 645, 584 A.2d 410 (1990)(fees to collect fees awarded in frivolous appeal of condemnation damages case). The *Ciaffoni* court justified its award of fees to recover fees thus: "Any counsel fees required to be expended as a result of that conduct should be paid by the party necessitating it, and the party awarded fees should not be required to expend any funds for counsel fees to recover court imposed fees. The *Ciaffoni* court further reasoned that the fees collectable may be significantly less than the fees expended to recover those fees, *Id*.

Some fee-shifting statutes explicitly authorize awarding fees on fees, see the Federal Civil Rights Attorney's Fee Award Act, 42 U.S.C. §1988, the intent of which is to encourage private attorneys general to enforce the public's interest in providing civil rights to all, *Tyler Business Services, Inc. v. National Labor Relations Board*, 695 F.2d 73, 74-75 (1982); *Hernandez v. Kalinowksi*, 146 F.3d 196, 199 (3d Cir. 1998) . In such cases plaintiffs may be considered "prevailing parties' for attorney's

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fees purposes if they succeed on any significant issue in litigation which achieves some of the benefit the parties sought in bringing suit., *Hensley v. Eckerhart*, 461 U.S. 424, 433 n. 7, 103 S. Ct. 1933, 1939, n. 7, 76 L. Ed. 2d 40, 50 n.7 (1983).

In New York, the courts have approved "fees on fees." *Sommer v. Creamer Adv.*, 13 Hous. Ct. Rptr. 356 (Civ. Ct., NY County 1985)(fees allowed under the Real Property Law §234); *Posner v. S. Paul Posner 1976 Irrevocable Family Trust*, 12 A.D. 3d 177, 784 N.Y.S. 2d 509 (1st Dept. 2004). In New Jersey, in the absence of a mandate based on statute, court rule or contract, attorneys' fees can be shifted from one party to another if equity demands it, *In Re Estate of Vayda*, 184 N.J. 115, 875 A.2d 925 (2005). New Jersey Rule of Court 4:42-9 provides certain exceptions to the American Rule, and its courts have some "carefully limited and closely interrelated exceptions to the American rule that are not otherwise reflected in the text of Rule 4:42-9," *Vayda Estate* at 121; *Matter of Reisen*, 313 N.J. Super. 623, 628, 713 A.2d 576 (1998) (attorney malpractice, attorney misconduct, recovery under a surety bond, and when an executor or trustee has committed "the pernicious tort of undue influence"). *Id*. For breach of duty by a *non*-attorney executor, such an award is paid from the estate even though prevailing party is not made whole thereby because he or she is also a beneficiary of the estate, *Vayda* at 184 N.J. 115, 875 A.2d 925 (2005).

Fees Taxed Against The Breaching Trustees: Relying on *Weiss Estate*, 4 Fid. Rep. 2d 71, 77 (Phila. O.C. 1983) and *Kline's Estate*, 280 Pa. 41, 124 A. 280 (1924) to invoke the general equity powers of the Orphans' Court, the Court determined that the Foundation should not pay the fees awarded, and awarded them all, including the fees on fees, against the breaching trustees as part of its surcharge for necessitating the prolonged litigation by their obdurate behavior prior to the litigation (Adjudication at 77).

Conclusion: This Opinion Summary could not do justice to this lengthy and interesting Adjudication wherein the Court judged the trustee's actions "on its own particular circumstances evaluated in light of the substantive law of Pennsylvania." *See* Restatement (Second) of Trusts §187 comment e (1957). The Court imposed no *per se* rules on a "complex nuance of facts." Many of the issues were novel, or based on unusual facts, thus yielding a fact sensitive result, from which we may still all learn something.

NEWSLETTER ARTICLES

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ETHICS COLUMN

By PAUL C. HEINTZ
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What Rules of Professional Conduct govern a lawyer asked to prepare a Will and Power of Attorney for a client whose capacity has been diminished by a stroke or Alzheimer's-type dementia?

Rule 1.14(a) of the Rules of Professional Conduct clearly provides that when a client's capacity is diminished "…the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client." Although another rule, Rule 1.4, does require the lawyer to maintain a reasonable level of communication with the client, the comment to that Rule recognizes that keeping the client fully informed may be impracticable when the client suffers from diminished capacity. Sometimes, members of the immediate family may discourage the attorney from attempting to meet with the client suffering from diminished capacity thinking erroneously that an estate planning session would not be possible or fruitful. Most lay people are unfamiliar with the elements of testamentary capacity and can easily become discouraged or even embarrassed by the mental state of their loved one. If it is clear to the lawyer that the client's estate planning requires review or change, the lawyer would seem to have an affirmative duty to try to meet with the client. To get around the barriers sometimes created by a well-meaning family, and when the client is in a facility such as a hospital or assisted living facility accessible to any visitor, a lawyer may be well-advised to visit the client without seeking the permission of the family or even advising of the intention to visit.

In carrying out his or her duties to maintain the lawyer-client relationship, the attorney also has an obligation to take whatever steps may be necessary to assure adequate communications. That would include meeting with the client alone and meeting on days and at hours and places that may be inconvenient for the lawyer. The lawyer must be willing to be patient and to allow more time with the client and to accept communications solely by head, eye or hand movements or barely legible writing.

Once access to the client with diminished capacity has been achieved and communications have begun, yet another and sometimes most difficult challenge arises: Determining whether the client can understand and communicate well enough to assist with the estate planning, so the lawyer may proceed with the effort.

The attorney should ask questions that will reveal whether the client knows his or her family, the "natural objects of his or her bounty", and the general nature of his or her estate. In the course of the conversation, which can be quite informal, the lawyer should elicit information sufficient to both initiate the estate planning project and assess the client's mental state. Even an easy going conversation, when properly guided by the lawyer, can be the equivalent of and as effective as the mini mental status exam so well known to psychiatrists and mental health workers. Through this process, the lawyer can reach the important conclusion that the client is appropriately oriented as to time and place and is not hiding significant mental impairment by obfuscation and dissembling. It is remarkable how socially adept clients suffering from significant mental impairment can make themselves appear perfectly normal during brief conversations.

Once the estate planning documents have been signed, it is imperative that the lawyer place in the client's file a comprehensive execution memorandum so the lawyer has a document to refresh his or her memory in the event the documents and their execution are ever questioned.

Above all, the lawyer must never forget that the true client in these situations is the client suffering from diminishing capacity and the lawyer must avoid being lulled into an ethical trap. The lawyer may neglect his or her obligation under Rule 1.2(a) to consult with the client as to the means by which the objectives of representation ought to be pursued. The lawyer may not be properly diligent as required by Rule 1.3, for instance, by failing to meet with the client and to discuss estate planning or other details with the client. The lawyer may fail to adequately communicate information to the client to enable the client to participate intelligently in decisions concerning the estate planning or other representation efforts as

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TAX UPDATE

By JOAN AGRAN
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I. COURT DECISIONS

Assets Transferred to FLP Included in Decedents' Estates Under Code Sec. 2036

In *Estate of Korby v. Comr., No. 06-1201 (CA 8 12/8/06)*, in 1993, husband, age 79, and wife, age 68, created a revocable trust, funding it with assets they owned jointly and individually. In 1994 they created a family limited partnership, to which they transferred $1,850,863 of stocks and bonds in exchange for a 98% limited partnership interest and to which the revocable trust transferred a money market account in exchange for a 2% general partnership interest. In 1995, the couple gave a 24.5% limited partnership interest to each of four irrevocable trusts created for their sons, applying a 43.61% discount.

In 1993, wife had been diagnosed with Alzheimer's dementia and moved to a nursing home. Husband was also in poor health and moved to the nursing home, where both resided until their deaths in 1998 within five months of each other. The partnership agreement provided for management fees to be paid to the revocable trust as general partner, in an amount determined by the general partner, and for the reimbursement of partnership expenses incurred by the general partner. From 1995 to 1998, the partnership made distributions totaling $120,795 to the revocable trust as general partner (used to pay husband's and wife's nursing home costs, taxes, medical bills, and other expenses) and made distributions totaling $34,562 to the sons' trusts as limited partners (intended to pay the limited partners' income taxes).

Husband's and wife's estate tax returns, filed in September 1999, included only the general partnership interest. The Service issued deficiency notices to both estates claiming that the full values of the partnership assets were includible in their gross estates under Code Secs. 2036(a)(1) and (2) and reducing each estate's adjusted taxable gifts to reflect the exclusion of the 1995 gifts of partnership interests.

On the basis of these facts, the Tax Court held that the couple had an implied agreement that the assets transferred to the partnership would be available to them for as

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required by Rule 1.4(b). The lawyer may also forget that there are some preparations necessary for appropriate representation under Rule 1.1 and the lawyer should always be wary of becoming an unwitting enabler when a family member is subtly exerting undue influence on the client to procure an *inter vivos* or testamentary gift.

To maintain his or her independence and to fulfill his or her ethical obligations in these situations, it is imperative that the lawyer meet with the client, obtain all substantive directions while alone with the client and avoid having the "helpful" parent or child serve as an intermediary for communication purposes or present when important documents are signed.

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

Send your questions and ideas to:

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Tax Update, continued

long as they needed income, thus causing assets to be included in each estate under Code Sec. 2036(a)(1). The estates appealed this decision.

The Eighth Circuit affirmed, holding that husband and wife retained for their lives the right to income from the assets transferred to the partnership. The court based its holding on that fact that: (i) the partnership made significant payments to the revocable trust over the remainder of husband's and wife's lives; (ii) there was no management contract between the partnership and the revocable trust; (iii) husband failed to keep track of the hours he spent managing the partnership; (iv) the partnership made payments to the revocable trust whenever husband requested them rather than according to a set schedule; and (v) husband did not report the payments as self-employment income, and (vi) most importantly, husband and wife, who were in poor health, did not retain sufficient income to cover their expenses after the transfers to the partnership.

The court further found no clear error in the Tax Court's conclusion that the transfers did not satisfy the Code Sec. 2036 exception for bona fide sales for adequate consideration. Husband stood on all sides of the transaction because he formed the partnership with the help of his estate planning lawyer, did not obtain his sons' involvement, and determined which assets to transfer to the partnership. In addition, there was no substantial business or other non-tax purpose for the partnership; rather the court concluded that husband and wife formed the partnership to make a testamentary transfer to their sons at a discounted value, while retaining access to the income from the transferred assets for their lives.

Estate's Stock Valuation Accounts for Foreseeable Repurchase of Some Shares and Sale Restrictions

In *Estate of Gimbel v. Comr., T.C. Memo 2006-270 (12/19/06)*, decedent died in 2000, with an estate that included 13% (over 3.6 million shares) of the outstanding, publicly traded common stock of the fifth largest metals service center company in the U.S. Between its 1994 initial public offering and decedent's death, the company completed 18 company acquisitions and two strategic asset purchases. In 2000, the company was negotiating its largest acquisition which would have used up most of the company's available cash and its line of credit.

On the date of decedent's death, 18,300 shares were publicly traded at an average per share price of $20.8125. Most of decedent's shares were unregistered and decedent was considered an affiliated person of the company because of the large number of shares she held. Pursuant to SEC Rule 144, the public resale of decedent's estate's shares was restricted to no more than 277,860 shares in any three-month period. The estate could sell the shares in a private placement but company's investment banking firm was unable to identify any private institutions or strategic investors interested in the estate's shares.

In 1994, the company's board adopted a formal stock repurchase plan that allowed the company to repurchase (at decedent's death) up to 6 million shares. From 1994 to decedent's death, the company repurchased in the public market approximately 1.37 million shares for $27 million. Two weeks before decedent's death, the company's CEO stated that the company would consider repurchasing shares at $19 per share. The company's board, after evaluating a repurchasing of some of the estate's shares in light of the impact on the pending acquisition, the company's need and ability to obtain additional financing, and the company's financial ratios, four months after decedent's death approved the repurchase of up to $50 million worth of the estate's shares at $19.35 per share. The company privately repurchased 63% (2.27 million shares) of the estate's stock for approximately $43.9 million.

Decedent's estate tax return valued decedent's company stock at $16.50 per share, or approximately $59.4 million total, which reflected an expert's discount of 20.72% off the trading price. On audit, the Service claimed that the discount should be reduced to 8%, for a total value of over $68.9 million. Both parties retained new experts for trial. The estate's new expert prepared a report applying a 17% discount to the estate's stock. The Service's new expert applied a 9% discount.

On the basis of these facts, the Tax Court held that the value of the stock was $64,320,892. The court held that it was reasonably foreseeable, as of the valuation date, that the company would repurchase 20% of the estate's stock and that the repurchase price would reflect a total 13.9% discount from the publicly traded price. The court held that the estate's remaining stock should be valued under the "dribble out" method (to reflect SEC Rule 144 restrictions) and that a total 14.4% discount should apply to those shares.

Although publicly traded stock is generally valued by averaging the highest and lowest

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quoted selling prices on the valuation date, the court noted that modifications can be made if the quoted selling prices do not reflect the value of the stock because of sale restrictions or other factors. In this case, the court agreed that a private market (other than a repurchase by the company) for the estate's stock did not exist. As to the foreseeability of the company's repurchase, noting that post-death events are generally disregarded unless reasonably foreseeable on the date of death, the court concluded that a repurchase of only 20% of the estate's stock was reasonably foreseeable at decedent's death. The court agreed with the estate's trial expert's use of the dribble out method to value the remainder of the estate's stock because of the Rule 144 restrictions.

Exercise of General Power of Appointment Results in Transfer Subject to GST Tax

In *Gerson Est. v. Comr., 127 T.C. No. 11 (10/24/06)*, decedent died in 2000, survived by four children and five grandchildren. Her Will exercised a general power of appointment in favor of her grandchildren over a marital trust created for her upon the death of her husband in 1973. The Service determined that the transfer to her grandchildren was subject to GST tax.

Although the GST tax does not apply to any generation-skipping transfer from a trust that was irrevocable on Sept. 25, 1985, under Reg. §26.2601-1(b)(1)(i), this does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer for estate tax or gift tax purposes. The estate argued that (i) the regulation is invalid, and (ii) the transfer qualifies for the grandfather exception. The Service disagreed, ruling that the disputed transfers in this case were not required under the trust, but were made at decedent's election and pursuant to the exercise of a general power of appointment; she was therefore deemed to be the owner of the property for purposes of the federal estate tax and the transfers were not eligible for exemption from the GST tax.

The Tax Court agreed with the Service, holding that Reg. §26.2601-1(b)(1)(i) is a reasonable and valid interpretation of the 1986 statute's transitional rule because it harmonizes with the plain language of the statute, its origin, and its purpose and therefore decedent's transfer to her grandchildren was subject to GST tax.

Conservation Easement Contribution not Deductible

In *Goldsby v. Comr., T.C. Memo 2006-274 (12/27/06)*, taxpayer is the income beneficiary and trustee of a trust created by his father, the remainder of which is to pass at taxpayer's death to his children. Although taxpayer and his wife reported all trust income on their individual income tax returns for the years in which the trust earned the income, taxpayer has not distributed all the net income which amounted to $2.2 million by 2000.

In 2000, the trust conveyed conservation easements on real estate owned by the trust and appraised at $5,640,000 to a Code Sec. 501(c)(3) charity. The trust reported the easement contribution on its 2000 income tax return and reported the entire income tax charitable deduction as passing through to taxpayer. Taxpayer and wife deducted a portion of the charitable contribution on their 2000 income tax return. They carried over the balance of the deduction subject to the Code Sec. 170(b) adjusted gross income limitations and deducted portions of it on their 2001-2004 returns. The Service issued a deficiency notice disallowing their 2002 income tax charitable deduction, challenging the value of the conservation easements and their eligibility to deduct the related charitable contribution.

On the basis of these facts, the Tax Court held that taxpayer and wife were not entitled to a deduction for the trust's charitable contribution of the conservation easements because they had failed to prove that the trust made the easement contribution from the income portion of the trust. The court concluded that taxpayer's failure to withdraw $2.2 million of income from the trust did not cause taxpayer to become the owner of the trust corpus because the trust income owed to taxpayer was wholly separate from the corpus.

In rejecting the argument under Code Sec. 678 that taxpayer was also the owner of at least part of the trust corpus because taxpayer left income undistributed, the court stated that (i) settlor did not intend for taxpayer to have any rights over the corpus other than to manage it for the remainder beneficiaries; (ii) taxpayer has no right to vest the trust corpus in himself; (iii) the trustee owes fiduciary duties to the remainder beneficiaries and must act for their benefit in dealing with the corpus; (iv) taxpayer never relinquished his claim to the undistributed income and, unlike the corpus, taxpayer could withdraw the undistributed income at any time; (v) the trust records showed the undistributed income owed to taxpayer; and (vi) the undistributed

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income was not commingled with trust corpus, and never became part of the corpus. Because the court held in favor of the Service on the issue of eligibility to take the deduction, it did not address the value of the easements.

Conservation Contributions Were Qualified

In *Glass v. Comr., 98 AFTR 2d 2006-5945 (2006, CA6)*, over a two-year period, taxpayers donated conservation easements on part of their property on the Lake Michigan shoreline, including much of a high, undeveloped bluff on that shoreline, to the Lake Traverse Conservancy Trust, an exempt organization dedicated to preserve land and wilderness for conservation and for the recreation and education of the people of Michigan. Taxpayers' property had three buildings on it, a log cabin, a guest house, and a garage. While the easements didn't restrict their use or enjoyment of the property, first as a vacation home, and later as their primary residence, they did limit the development of the encumbered shoreline, preventing taxpayers from building on the property's lake-front lots. Taxpayers could still develop the portion of their property unencumbered by the conservation easements in any way consistent with the zoning requirements.

The Service denied taxpayers' deduction for the value of the donated easements, claiming the easements weren't exclusively for conservation purposes. Taxpayers went to the Tax Court which held that (i) the easements satisfied the conservation purposes test because they protected a relatively natural plant or wildlife habitat and (ii) taxpayers also met the exclusive purposes requirement.

The Service appealed to the Sixth Circuit, arguing that (i) the Tax Court's construction of Reg. §1.170A-14(d)(3)(i) and Reg. §1.170A-14(d)(3)(ii) was erroneous because it read the word "significant" out of the reg, and thus erred in concluding that the encumbered property satisfied Code Sec. 170(h)(4)(A)(ii), (ii) the Tax Court's findings that the encumbered property fell within Reg. §1.170A-14(d)(3)(i) were clearly erroneous because the encumbered property was too small, allowed taxpayers too many retained rights, and failed to restrict the building rights of neighboring property owners, thus precluding the easements from serving their stated conservation purpose, and (ii) the Tax Court erred in finding that the easements' conservation purpose was protected in perpetuity, and that the deductions were "exclusively for conservation purposes" as required under Code Sec. 170(h)(5)(A) , Reg. §1.170A-14(e) , and Reg.§ 1.170A-14(g) .

The Sixth Circuit affirmed, holding that the Tax Court's findings were not clearly erroneous and there was no error in the court's application of the law. The court held that (i) the Tax Court properly construed Code Sec. 170(h)(4)(A)(ii) and Reg. §1.170A-14(d)(3)(i) and Reg. §1.170A-14(d)(3)(ii), noting that while it is true that the relatively natural habitat where a wildlife or plant community normally lives must be significant to meet the "conservation purposes" test, habitats for rare, endangered, or threatened species of animals or plants are expressly recognized as significant under the regs., (ii) the easements were carefully drawn to prohibit any activity or use of the encumbered property that would undermine their stated conservation purpose; therefore the court did not err when it found that the conservation easements "protect and preserve significant natural habitats by limiting the development or use of the encumbered shoreline," and (iii) after examining the terms of the conservation easements, the trial testimony, and the statutory requirements, the Tax Court correctly concluded that the contributions met the "exclusively for conservation purposes" requirement of Code Sec. 170(h)(5).

Misappropriated Trust Fund Assets Included in Decedent's Gross Estate

In *Estate of Hester v. U.S., 99 AFTR 2d 2007-1288 (W.D. Va. March 2, 2007)*, decedent was the trustee and income beneficiary of a trust created for his benefit by his predeceased wife. The couple's children were the remaindermen. Decedent breached his fiduciary duty, transferring all of the trust's $3.2 million in cash into his individual brokerage account and a $1.25 million promissory note to himself. Decedent then engaged in a pattern of unsuccessful day-trading. The commingling reached a point where it was impossible to determine which interests belonged to decedent and which interests belonged to his children.

The executor of decedent's estate originally filed an estate tax return which included the value of the remaining misappropriated assets and claimed no deduction for any claims of the trust remaindermen. The estate later claimed an estate tax refund on the alternative theories that (i) the misappropriated assets should not have been included in the gross estate, because decedent possessed no interest in the assets after his breach of fiduciary duty, but merely held the assets in a constructive trust for the remaindermen, or (ii)

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if the misappropriated assets were includible in the gross estate, then an offsetting deduction of equal value should be allowed for claims against the estate under Code Sec. 2053(a)(3) or for indebtedness with respect to property that is included in the estate under Code Sec. 2053(a)(4).

On the basis of these facts, the district court first found that (i) the misappropriated assets were includible in decedent's gross estate under Code Sec. 2033 because decedent had exercised dominion and control over the assets as though they were his own, without an express or implied recognition of an obligation to repay the beneficiaries, (ii) no deduction was allowable under Code Sec. 2053(a)(3) because the trust's remainder beneficiaries had never made a claim against decedent or his estate, nor was there evidence to suggest that decedent or his estate expected such a claim to be made or paid, and (iii) the estate was barred from taking a deduction under Code Sec. 2053(a)(4) for indebtedness with respect to property that is included in the gross estate, because decedent's personal acquisition of funds in violation of his fiduciary duty did not create an indebtedness.

Estate Denied Deduction and Refund Because Wife did not Have Enforceable Claim Against Estate

In *Gottesman v. U.S., No. 05 Civ. 8212 (S.D.N.Y. 1/12/07)*, wife agreed, pursuant to a separation agreement, to transfer to husband her 35 shares in a company in which husband owned the remaining 55 outstanding shares. In return, husband promised that if during wife's lifetime, husband received value in connection with a merger or sale of the company, he would pay wife an amount equal to 35/90 of the value. Value as defined in the agreement did not include any amounts received by any of the parties' children. The term 'husband' was defined to include husband's estate, or any trusts created by him during his lifetime. Husband executed an escrow agreement under which 35 shares were placed in escrow as security for the performance of several of husband's obligations to wife, as detailed in the separation agreement. The pledged stock was to remain in escrow until the earliest occurrence of certain conditions, including a merger or sale of the company.

When husband died in 1990, he bequeathed all of his shares in the company to his children, of which 25.5 shares remained in escrow. These shares continued to remain in escrow to protect wife from a default on the estate's outstanding obligations to her. In 1991, the estate filed a federal estate tax return that showed an estate tax due in the amount of $17,810,369. The IRS audited the return and determined that the tax due totaled $20,990,352, which the estate paid.

In 2000, the children sought to sell the company. Because they believed they did not have unencumbered title or possession of the shares in escrow, the children, the estate, and wife entered into a settlement agreement whereby the children agreed to pay wife $10,000,000, and in exchange wife agreed to terminate the escrow agreement and release the shares. The estate filed a refund claim in 2002 for $4,156,696, plus interest which the Service disallowed and the estate filed a refund action.

On the basis of these facts, the court held that:

1. Wife did not have a valid claim against the estate for a portion of the proceeds from the children's sale of the company's shares, and the estate cannot claim a deduction under Code Sec.2053. The formulas in the separation agreement protected wife's right to share in the proceeds of a sale or merger of the company by husband or his estate, but not in the subsequent sale of the company by the children. The separation agreement expressly excluded from value any amounts received by the children with respect to shares of stock or other interest in the company transferred by husband or his estate to one or more of the children.

2. The estate did not qualify for a deduction under Code Sec.2031; wife did not have a valid claim against the estate based on the merger or sale language of the separation agreement and therefore there was no liability by which to reduce the value of the gross estate.

3. The estate was not entitled to a deduction under Code Sec.2056(a); because husband bequeathed his interest in the company shares to the children, and the children subsequently made a payment to wife, no property interest in the company shares passed from the decedent to his surviving spouse under Code Sec.2056(a).

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Estate not Entitled to Family-Owned Business Deduction

In *Estate of Keeton v. Comr., TC Memo. 2006-263 (Dec. 13, 2006)*, decedent owned 100% of the stock of two companies, one incorporated in 1985 and the other in 1995. He materially participated in the business of both corporations and upon his death his interests passed to his daughter, who continued to operate the businesses. Decedent's estate claimed a QFOBI deduction under Code Sec. 2057 for the aggregated value of the businesses. The Service denied the deduction.

In the Tax Court, the estate asserted that the value of the two companies should be aggregated because the incorporation of the second company was a continuation of the business of the first company and that decedent satisfied the 50% test under Code Sec. 2057(b)(1)(C). Although the estate and the Service had stipulated that the "combined value" of the companies exceeded 50% of the adjusted gross estate, the statute requires that the "adjusted value" exceed 50% of the adjusted gross estate. After taking a deduction for claims against the estate (the value of which the estate and the Service had also stipulated to), the estate no longer met the 50% test. Therefore, the court concluded the estate was not entitled to the QFOBI deduction and did not examine the issue of whether the estate could aggregate the value of the businesses. The court also rejected the estate's argument that the Service's position contradicted its stipulated facts and that the Service had raised this issue for the first time in its opening brief.

II. IRS REVENUE RULINGS, REVENUE PROCEDURES & NOTICES

Appeals Settlement Guidelines For FLPs and Family LLCs Issued

The Service has issued Appeals Settlement Guidelines for family limited partnerships and family limited liability companies. The Guidelines focus on four key issues: (i) discounts for the transferred interests; (ii) includibility in the estate under Code Sec. 2036 or Code Sec. 2038; (iii) indirect gifts of the entity's underlying assets; and (iv) whether accuracy-related penalties should be imposed. In addition, the Service examines a number of cases addressing these issues.

<u>Discounts</u>. This issue examines whether the fair market value of transfers of family limited partnerships or family limited liability companies interests by death or gift is properly discounted from the pro rata value of the underlying assets. The Guidelines, which examine recent cases in this area, note that cases in this area are fact specific and that, as a result, each case needs to be individually assessed to determine the appropriate discounts. The guidelines state that, in certain cases, such as where the entity holds only liquid assets, there should be only a minimal discount from the pro rata value of the underlying assets and that the appeals officer should carefully review the appraisal based on the analysis in these cases, looking to afford smaller discounts on the portion of the entity's assets that are publicly traded or liquid.

<u>Validity issue</u>. This issue examines whether the transferred interests should be included in the transferor's estate at their fair market value as of the date of his death under Code Sec. 2036 or Code Sec. 2038. The Service's position is that, where the facts and circumstances indicate the decedent retained a sufficient interest in the transferred property, the property is includible under Code Sec. 2036 or Code Sec. 2038. The Service's position is that the assets transferred to the family limited partnership and family limited liability company should be included in the deceased transferor's gross estate, without discounts, where the facts justify that result. The Service initially provided a list of factors to be considered, but it was removed before public release. Again a number of cases addressing these issues are examined.

<u>Indirect gifts</u>. This issue looks at whether there is an indirect gift of the underlying assets, rather than the FLP interests, where the transfers of assets to the family limited partnership occurred either before, at the same time, or after the gifts of the limited partnership interests were made to family members.. The Service's position is that, under current law, the transfers of assets to a family limited partnership or family limited liability company after transfers of limited partnership or membership interests to other family members are indirect gifts to which discounts are inapplicable.

<u>Accuracy-related penalties</u>. The Guidelines examine the circumstances under which the Service may seek to impose accuracy-related penalties under Code Sec. 6662. Accuracy-related penalties under Code Sec. 6662 may apply where the discounts claimed are particularly egregious or if there is evidence of negligence.

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Guidelines on Charitable IRA Rollover

In *Notice 2007-7, 2007-5 IRB (Jan. 11, 2007)*, the Service has clarified the rules regarding charitable IRA rollovers under Code Sec. 408(d)(8). Among the points clarified are the following:

1. A qualified charitable distribution can be made to honor previous outstanding pledges.

2. A distribution is deemed to have been made "directly by the trustee" to the charity if the trustee delivers (or mails) a check payable to the charity to the donor, who then delivers or mails it to the charity.

3. A qualified charitable distribution can be made from an inherited IRA, as long as the beneficiary who inherited the IRA is at least 70 1/2 years of age.

4. A qualified charitable distribution can be made by the participant in a SIMPLE IRA or SEP IRA if the donor is at least 701/2 years of age and did not make contributions to the plan within the same qualified plan year as the year in which the distribution is made.

5. The IRA administrator is not liable for failing to withhold income tax on a nonqualifying charitable distribution, if he relied on reasonable representations that the owner intended the distribution to be a qualified charitable distribution.

6. A 2006 distribution made before August 17, 2006, may still be a qualified charitable distribution if the other requirements were met.

7. The donor cannot receive any benefits from the transaction, such as preferred seating at sporting events, dinners or raffle tickets.

8. The $100,000 maximum qualified charitable distribution in each of 2006 and 2007 applies on a per donor basis, not on a per IRA basis.

Sale of Life Insurance Policy to Irrevocable Grantor Trust not a Transfer for Value

In *Rev Rul 2007-13, 2007-11 IRB (March 12, 2007)*, the Service ruled that the grantor of a grantor trust is deemed, for transfer-for-value purposes, to own the policies of insurance on his or her life that are held by the trust. The ruling presented two situations, neither of which was a transfer-for-value under Code Sec. 101(a)(2). In Situation 1, the insured created and funded two grantor trusts; the trustee of Trust 2 sold a life insurance policy to the trustee of Trust 1, for its fair market value. In Situation 2, the same facts existed, except that Trust 2 was not a grantor trust.

Citing *Rev Rul 85-13, 1985-1 CB 184*, the Service stated that in Situation 1, there was no transfer for income tax purposes, because the grantor was deemed to own the policy both before and after the transaction. Because the grantor is treated as the owner of both Trust 1 and Trust 2 for federal income tax purposes, the grantor is treated as the owner of all the assets of both trusts, including both the life insurance contract and the cash received for it; accordingly, there has been no Code Sec.101(a)(2) transfer of the contract in Situation 1.

In Situation 2, there was a Code Sec.101(a)(2) transfer of the life insurance contract for valuable consideration because the grantor is treated as the income tax owner of all Trust 1 assets but not the Trust 2 assets. Nevertheless, the Code Sec.101(a)(2) transfer for value limitations do not apply because the transfer to Trust 1 is treated as a Code Sec.101(a)(2)(B) transfer to the insured, because the grantor was the deemed owner of the assets of Trust 1, the transferee trust.

III. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

Grantors and Others as Substantial Owners of Trust

In *PLR 200647001*, grantor executed a trust, appointing a corporate trustee; the trust provides that during grantor's lifetime, the trustee will pay over or apply such sums of net income and principal as: (i) a Distribution Committee by unanimous agreement shall appoint; or (ii) grantor and one member of the Distribution Committee by unanimous agreement shall appoint, to or for the benefit of one or more members of a class consisting of grantor, his spouse, his father, his mother, his descendants, his brother, brother's spouse, brother's descendants, and any organization described in Code Secs. 170(c), 2055(a) and 2522(a)). Any net income not so paid over or applied

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shall be accumulated and added to the principal of the trust at least annually and thereafter shall be held, administered and disposed of as a part of the trust corpus.

Upon grantor's death, the residue of the trust, is to be distributed in accordance with grantor's exercise of a limited testamentary power of appointment. Grantor may, during his lifetime, by a written, acknowledged instrument delivered to the trustee, release the power of appointment with respect to any or all of the property subject to the power or may further limit the persons or entities in whose favor or the extent to which the power may be exercised.

To the extent grantor does not effectively exercise his power of appointment, the residue of the trust is to be distributed to qualified charities to be selected by the trustee. The trust provides that the Distribution Committee shall initially consist of grantor's brother and a nephew, and that during grantor's lifetime, there will always be two members of the Distribution Committee.

On the basis of these facts, the Service ruled that:

1. Grantor will not be treated as the owner of the trust under Code Secs. 673, 674, 676, or 677, and that whether grantor can be treated as the owner of the trust under Code Sec. 675 is a question of fact to be determined after returns are filed;

2. Citing Regs. §25.2511-2(b), in view of grantor's retained limited testamentary power, grantor's transfer of property to the trust will not be a completed gift. Citing Regs. §25.2511-2(f), grantor will be treated as making a taxable gift at such time as trust corpus or income is distributed to a beneficiary other than grantor, or if, during grantor's lifetime, grantor releases grantor's retained power to appoint the trust property.

3. Any distribution of property from the trust to grantor by the Distribution Committee will not be a completed gift subject to federal gift tax. In addition, citing Regs. §25.2514-3(b)(2), brother and nephew will not have a general power of appointment by reason of the joint distribution power, and therefore during the period the Distribution Committee consists of brother and nephew, neither brother nor nephew will be treated as making a taxable gift if trust income or corpus is distributed to grantor under the terms of the trust.

Shares Aggregated for Valuation Purposes but Shares Passing to Charity Valued as a Minority Interest

In *TAM 200648028*, (in addition to many other issues that were presented) decedent created a trust for his own benefit, funding it with a minority interest in voting stock in a closely held corporation. Decedent served as a co-trustee of the trust until his death and held various powers over the trust, including the power to designate the remainder beneficiary. The trust did not have a separate bank account; it did not make formal accountings; all amounts received by the trust were deposited into the decedent's bank account from which the trust's operating expenses were paid; and creditors could reach decedent's interest in the trust. Decedent also held voting and nonvoting corporation stock outright. Decedent's estate tax return valued the corporation's shares held by the trust, which passed to charity, separately from the corporation's shares decedent had owned outright, applying a minority interest discount to the value of the shares, as well as a lack of marketability discount.

On this issue, the National Office advised that the Code Sec. 2031 fair market value of the stock that is includible in decedent's estate under Code Secs. 2036 and 2038 should be determined by aggregating the stock decedent owned outright with the stock owned by the trust into a single block. However, in determining the estate's allowable Code Sec. 2055 charitable deduction, the National Office advised that the shares passing to charity should be valued separately as a minority interest.

Disclaimer of Property in Favor of Private Foundation Qualified Under Code Sec. 2518

In *PLR 200649023*, grantor died, survived by spouse, son, and daughter. A trust created by grantor gave his daughter the power to appoint within one year of grantor's death, a sum certain from the trust for any purpose, in any amounts, shares or proportions and on such terms and conditions to or for the use and benefit of any one or more person(s) as daughter, in her sole and absolute discretion, shall appoint, other than (ii) any of daughter or grantor's other issue, the estate of any such issue, the creditors of any such issue, or the

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creditors of the estate of any such issue; and (ii) any person related to grantor by blood or by marriage at any time, such persons estate, such person's creditors, or the creditors of such person's estate. To the extent that daughter fails to validly appoint all or any portion of such sum within one year of grantor's death, the trustees were directed to distribute any unappointed property, along with the residuary of the trust, to a foundation created by grantor. Upon grantor's death, daughter and son were named as trustees of this trust.

The agreement governing the foundation provided that daughter was appointed successor trustee of the foundation following decedent, and in addition, daughter was given the authority to appoint an additional trustee and to amend the trust agreement, provided that no amendment disqualified the foundation from exemption under Code Sec. 501(a).

Daughter proposes to disclaim her right to appoint the sum certain under the trust. In compliance with state law, the proposed disclaimer will be made in writing and will be delivered to the Executors of grantor's estate within nine months of grantor's death. Prior to executing the proposed disclaimer, daughter also proposes to amend the foundation agreement so that daughter will have no rights or powers with respect to the disposition of the disclaimed property passing from the trust to the foundation. Any property received by the foundation as a result of daughter's disclaimer will be held in a segregated account. The right to distribute income and/or principal of the segregated account and to select recipients of such distributions will be held exclusively by the special trustees appointed by daughter who cannot be daughter, any other issue of grantor, the spouse of any issue of grantor and any entity in which daughter has an interest or serves as an officer, director or employee. At daughter's death, the segregated account will be merged with other foundation property, and all rights, powers and duties of the special trustees will terminate. After the foundation's agreement is amended, daughter will appoint a co-trustee of the foundation, so that the co-trustee may appoint the special trustee to implement and administer the segregated account.

On the basis of these facts the Service ruled that (i) the proposed disclaimer will constitute a qualified disclaimer under Code Sec. 2518 provided the disclaimer otherwise complies with the requirements of Code Sec. 2518 and provided the agreement that governs the foundation is amended as proposed and the terms, as amended, are effective under state law, and (ii) the property that passes to the foundation as a result of daughter's disclaimer that will be in the segregated account will qualify for an estate tax charitable deduction under Code Sec. 2055.

Reformed Trust not to be Treated as a Charitable Remainder Trust

In *PLR 200649027*, two individuals created a net-income with make-up charitable remainder unitrust naming themselves as trustees and current income beneficiaries. After petitioning a local court, the two individuals obtained a court order to reform the trust by changing it to a standard charitable remainder unitrust, subject to receipt of an IRS letter ruling that the reformation would not disqualify the trust under Code Sec. 664.

Two arguments were advanced for the reformation, (i) the attorney who drafted the trust did not advise them of the availability and advantages of a standard charitable remainder unitrust and, had they been so advised, they would likely have opted for a standard charitable remainder unitrust, and (ii) changes in the investment climate, particularly the reduction in interest rates in recent years, have frustrated the trust's purpose of providing them with a suitable annual income stream.

On the basis of these facts, the Service ruled that the reformed trust would not be treated as a charitable remainder trust. Citing Regs. §1.664-3(a)(4), the IRS explained that a charitable remainder trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than a Code Sec. 170(c) organization. According to the IRS, a reformation or modification does not violate Code Sec. 664 if the modification or reformation corrects a scrivener's error. In this case the judicial reformation of the trust did not result from a scrivener's error and would violate Code Sec. 664.

Estate's Distribution to Charity of Right to IRD Does not Accelerate Tax

In *PLR 200652028*, decedent's probate estate passed under the terms of his Will to a trust that he had created during his lifetime. At decedent's death, a portion of the trust's residue is to be distributed to two charities. The trust provides that the trustee may make distributions in cash or in kind and the trustee is not required to make pro rata distributions. Decedent intended to name the trust as the beneficiary of his three IRAs but mistakenly named his estate as beneficiary. At the request

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of decedent's estate, a local court reformed each IRA's beneficiary designation to designate the trust as beneficiary. The trustee plans to fund the residuary charitable bequests under the trust by assigning the IRAs to the two charities in satisfaction of their shares.

On the basis of these facts the Service ruled that the trustee's assignment of the IRAs to the two charities in satisfaction of their trust shares will not be a Code Sec.691(a)(2) transfer. Only the charities will include the amounts of Code Sec.691 IRD from the IRAs in their gross incomes when the charities receive distributions from the IRAs. Citing Regs. §1.691(a)-4(b), the Service stated that if the decedent's estate or any person transmits the right to IRD to another who would be required by Code Sec.691(a)(1) to include the IRD in his or her income when received, then only the transferee will include the IRD in his or her income when received. In this situation, a Code Sec.691(a)(2) transfer has not occurred. If a right to IRD is transferred by an estate to a specific or residuary legatee, under Regs. §1.691(a)-4(b)(2), only the specific or residuary legatee must include the IRD in income when received.

QTIP Election Null and Void Where not Necessary to Reduce Estate Tax Liability to Zero

In *PLR 200702018*, after provision for a number of specific bequests, decedent's trust directed that the remainder be divided into a Marital Share and a Family Share, and further directed that a marital deduction should be taken with respect to the Marital Share. During wife's life, both shares provide that income is to be paid to wife at least quarter-annually, and distributions of principal may be made to wife for her health, maintenance and support. In addition, wife has the power to withdraw annually the greater of $5,000 or 5% of the value of the principal of the Marital Share. On wife's death, the trustees are to pay wife's estate the amount of federal estate and state death taxes owed by her estate with respect to the inclusion of the principal of the Marital Share in her estate, with the remaining principal of both shares then distributed to decedent's living children in ten annual payments. The estate elected QTIP treatment on the federal estate tax return for the entire date-of-death value of decedent's trust.

On the basis of these facts, the Service ruled that: (i) the specific bequests do not qualify for the marital deduction because they are made to individuals other than the decedent's surviving wife and therefore the marital deduction taken with respect to the value of the specific bequests is void, and (ii) the QTIP election made with respect to the value of the property passing to the Family Share was not necessary to reduce the estate tax liability to zero; the estate tax would have been zero whether or not the election was made with respect to the Family Share, and therefore the QTIP election with respect to the value of the property passing to the Family Share is null and void for purposes of Code Secs. 2044 and 2056(b)(7), (iii) wife will not be treated as making a gift under Code Sec.2519 if she disposes of her income interest with respect to the Family Share, and (iv) wife will not be treated as the transferor of the specific bequests or the property in the Family Share for generation-skipping transfer tax purposes under Code Sec. 2652.

Qualified Profit-Sharing Plan Distribution to QTIP Trust Does Not Accelerate IRD

In *PLR 200702007*, decedent, a participant in a qualified profit-sharing plan, designated a QTIP trust as beneficiary of his interest in the plan. On the decedent's death, assets were distributed from the plan to the QTIP trust.

Qualified plan distributions to a deceased employee's estate or beneficiaries are treated as IRD. Under Code Sec. 691(a)(1), IRD must be reported for the tax year when received by the person who acquires the right from the decedent by bequest, devise, or inheritance, if the amount is received after distribution by the decedent's estate of the right to the income. Under Code Sec. 691(a)(2), a transfer by a decedent's estate or by the heir, devisee or other beneficiary of a right to IRD is considered as the realization of the decedent's income. For the tax year of the transfer, the transferor who received the right by reason of the decedent's death must include in gross income the full fair market value of the right as of the time of the transfer, plus the amount by which any consideration for the transfer exceeds the fair market value. Transfer does not include (i) transmission at death to the decedent's estate, or (ii) a transfer to a person under the transferee's right to receive the amount by reason of the decedent's death or by bequest, devise, or inheritance from the decedent.

Based on the facts presented, the Service concluded that the designation of the QTIP trust as beneficiary of the decedent's interest in the profit-sharing plan did not result in the acceleration of IRD at the time assets from the

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plan passed into the trust and that the amounts of IRD in the plan will only be included in the gross income of the QTIP trust's beneficiary (the decedent's surviving spouse) when she receives a distribution from the trust.

Restorative Payment for Bad IRA Investment Advice Eligible for Late Rollover

In *PLR 200705031*, decedent, in 1988 on advice of an investment manager, invested his IRA in mutual funds of the company that held the IRA. The investments fared poorly and decedent wrote letters to the company that employed the investment adviser, alleging that the adviser's recommendations were unsafe, were not prudent or appropriate, were motivated by a desire for commissions, and didn't meet decedent's retirement objectives, and were not made in decedent's best interests. Decedent died in 2004 without resolving the matter and without either seeking arbitration or suing either company to recover his losses.

Decedent's wife, the IRA's sole beneficiary, continued to seek recovery of the losses. In 2004, the investment adviser's employer settled by sending wife a check for the decline in value that the IRA suffered between 2000 and 2004, which amount was placed into a non-IRA account. Wife was not aware that she might be eligible to roll over the settlement until she talked to an attorney in 2005, as neither company involved informed her of the tax ramifications of the settlement amount.

On the basis of these facts the Service ruled that, although generally payments made to an IRA to make up for losses due to market fluctuations or poor investment returns are generally treated as contributions, the payment to wife was the result of an arm's-length settlement of a good faith claim of liability, and, as such, was a restorative payment rather than an additional contribution to an IRA made to merely replenish the account balance after investment losses. This conclusion wasn't altered by the fact that neither taxpayer nor his wife filed a lawsuit or sought arbitration to recover the IRA's losses. The Service also ruled that the settlement payment was eligible to be rolled over into an IRA set up in wife's name. The Service waived the usual 60-day rollover requirement on the ground that wife had received "inappropriate advice" about the nature of the settlement payment, and because there was a dearth of advice on how to handle such payments. Wife was granted 60 days from the date of the private ruling's issuance to roll over the settlement payment into an IRA.