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Probate and Trust Law Section Newsletter

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Report of the Chair

By SUSAN G. COLLINGS
DRINKER BIDDLE & REATH LLP

The year marches on and our Section's committees have been very busy. While it would take too long to report on all of their activities, here are some highlights. The Education Committee, which is chaired by Laura Stegossi, has presented two informative and timely programs. The first, presented at our March Quarterly lunch and titled "Trusts: Drafting Well to Administer Well," included thoughtful discussion about drafting tips and pitfalls from the perspective of the corporate fiduciary and the practitioner. This was followed by the June program, "Trust and Estate Planning in 2013 and Beyond," which provided a comprehensive analysis of the impact of ATRA on estate and income tax planning. We are grateful to the panelists on these programs for sharing their time and expertise and also to the course planners and Committee members who time and again bring us these high-quality educational programs.

The Legislative Committee, led by Michael Stein, has been busy exploring several different areas of possible legislation. The Committee completed a draft of a "Directed Trustee" statute and has forwarded it to the Pennsylvania Bankers' Association for review and comment. Additionally, the Committee has begun working on a statute to address issues concerning digital assets.

The Committees continue to serve as an important forum for discussion and education on a broad range of topics. To wit, the Tax Committee, chaired by Rebecca Rosenberger Smolen, has recently offered several informative and practical programs—one on preparation of Gift Tax Returns and one on preparation of the Federal Estate Tax Return. Similarly, the Orphans' Court Litigation Committee, chaired by Tim Holman, has in its recent meetings, addressed topics such as use of mediation in Orphans' Court practice, guardianships and the Older Adults Services Act, and the Elder Law and Guard-

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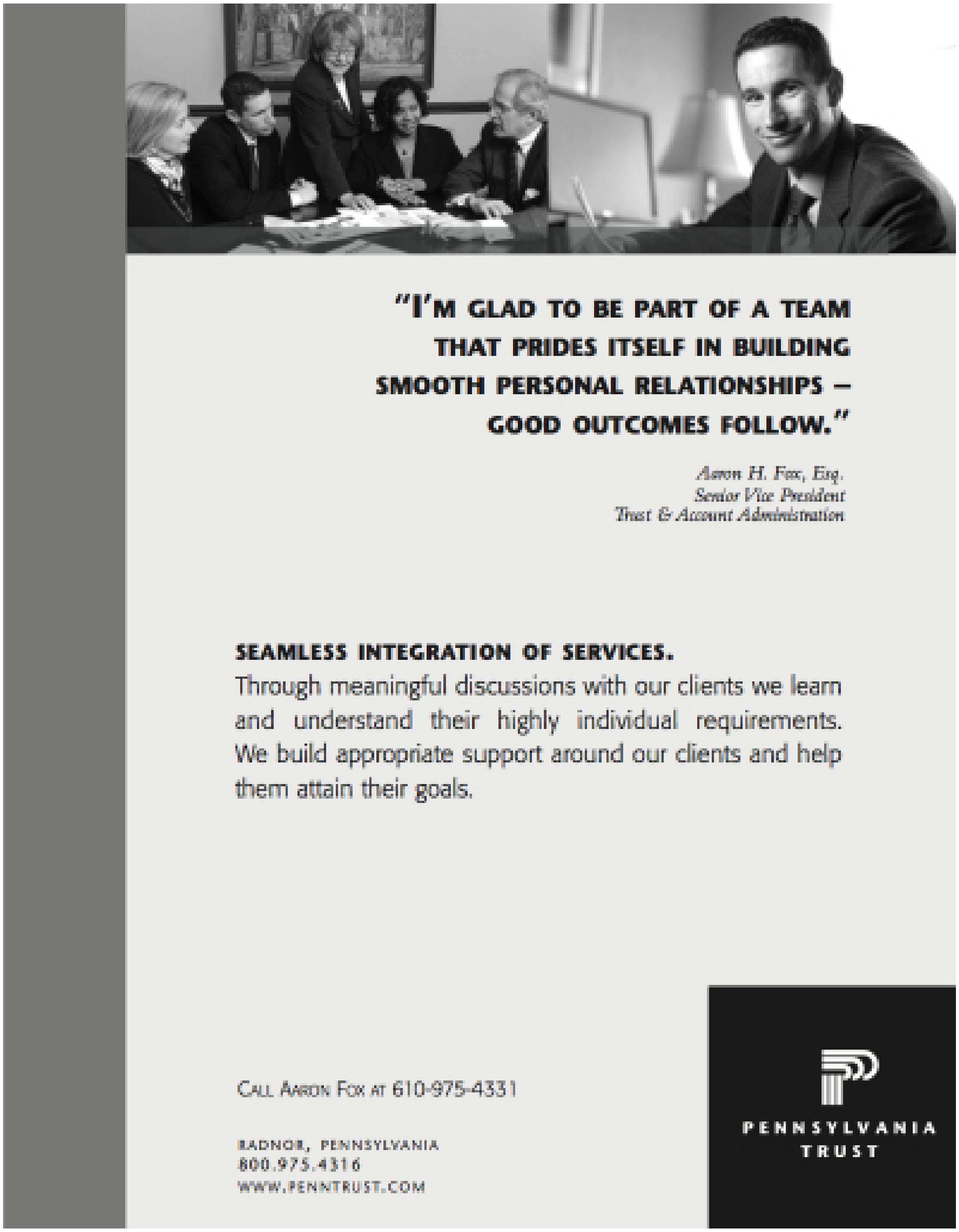

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Playing By New Rules

How Recent Changes in the Tax Code May Affect Trust and Estate Income in 2013 and Beyond

By ROSS E. BRUCH
SAUL EWING LLP

Additional Income Tax to Trusts and Estates

Effective as of January 1, 2013, many individuals, trusts and estates are subject to a 3.8% "Medicare Tax" on undistributed net investment income (NII) above certain thresholds. Unfortunately for trusts and estates and their beneficiaries, this tax applies even at low income levels, requiring that most fiduciaries, and not just those that administer trusts and estates with significant assets or wealthy beneficiaries, will need to consider carefully this new tax as part of their fiduciary duties. Additionally, clients and their attorneys will now need to evaluate how to address the impact of this tax when creating new trusts and wills or modifying existing ones.

The Medicare Tax was implemented under §1411 of the Internal Revenue Code as part of the Health Care and Education Reconciliation Act of 2010. While this tax will have a financial impact on many individual taxpayers and may lead to some planning on their part to avoid the additional costs, it will play a much more significant role in the administration of trusts and estates. Regrettably for trusts and estates, the §1411 tax applies to the lesser of a trust's or estate's undistributed NII or its modified adjusted gross income (MAGI) above $11,950. This miniscule threshold is far less than the §1411 tax's $200,000 minimum MAGI requirement for single taxpayers or the $250,000 minimum for married taxpayers filing jointly. The tax pertains to three types of income: passive-type income such as interest, dividends, rents and royalties; "net gain" attributable to the disposition of property; and, "other gross income" derived from a passive activity trade or business. All Subchapter J trusts are subject to the tax unless specifically excepted by the Code. These exceptions include tax-exempt trusts, such as charitable remainder trusts, business trusts, foreign trusts, and grantor trusts.

Based on this tax, a trust or estate with very low earnings may pay a top rate of 43.4% on income over $11,950 (as a result of an increase in the top trust and estate tax bracket under the American Taxpayer Relief Act (ATRA)) on its undistributed NII. This is equivalent to what an individual with a MAGI over $400,000 would pay on the same NII. A disparity between taxable thresholds of individuals and trusts is a problem that most trustees are already familiar with, but usually to a lesser degree in prior tax years. Fiduciaries have also previously wrestled with the tension between leaving money in trust to grow for the benefit of future generations and distributing the assets to current beneficiaries. The §1411 tax will undoubtedly increase this tension. As a result, fiduciaries will be forced to examine on an annual bases the best method of administering their trusts and estates and perhaps drastically alter investment and distribution approaches.

Planning

Planners need to fully understand the tax implications of their clients' estate plans in order to ensure they efficiently and effectively meet their

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Report of the Chair, continued

ianship Committee, co-chaired by Howard Soloman and Linda Hee, held a program focusing on reverse mortgages. Additionally, the Publications Committee, chaired by David Ruben, continues to provide helpful articles on many topics.

Our newly formed Diversity Committee, led by David Schwartz, is working hard to foster diversity within our Section. To this end, the Committee is reaching out to other sections and affinity groups to promote interest in our Section's work. In concert with this effort, Alison Altman-Gross of our Young Lawyers Task Force has established a mentoring program to match experienced practitioners with young lawyers.

If you are not already participating in one of our Committees, please consider joining one and sharing your experience and knowledge.

Playing by New Rules, continued

intended goals in 2013 and in future tax years. In some instances, it will be impossible to avoid increases in trust or estate tax rates, but there are several things to keep in mind when trying to reduce the tax burden due to these new rules:

- **Distribute Income.** The primary way for fiduciaries to reduce the 3.8% tax is to distribute NII. Since the tax only apply to undistributed income, any income that is distributed to beneficiaries is not taxed to the trust or estate. However, depending on the type of income and the MAGI of the recipient taxpayer, beneficiaries may need to recognize these distributions as taxable gains. Therefore, any distribution of income made to reduce trust or estate income tax could result in a zero-sum game where the receiving beneficiary needs to pay tax equal to what the trust or estate would have been subject to.

- **Constantly Evaluate.** Fiduciaries, planners, and accountants need to take a collective approach to determine the best result for each trust and estate with which they are involved. This evaluation should not only occur at the creation of a trust, but should be done annually to ensure the trust's intended goals and ideal tax efficiency are being met. When evaluating whether to make a distribution, this team should examine the tax rates of the trust and its beneficiaries (possibly including the projected future rates of contingent beneficiaries) as well as the current and future financial needs of all beneficiaries. At times, the most efficient tax outcome may produce the "best" overall result for all parties involved, but that will not always be true.

- **Pro Rata Distributions.** Fiduciaries must also remember that some income to the trust may not qualify as NII. Any distributions made to beneficiaries are considered pro rata distributions of the various classes of income the trust receives. Therefore, simply because a trustee distributes an amount equal to the NII received by the trust does not mean that all of the NII has necessarily been distributed.

- **Be Flexible**. Flexibility in a trust's distributions is important to producing an efficient tax structure. If a trust permits its fiduciary to delay or accelerate distributions or to make unequal distributions to beneficiaries, the fiduciary will be able to adjust the amount and timing of income distributions and reduce the tax owed. This will be especially true if the trust's beneficiaries are spread across different income levels and require distributions in different tax years. However, it is important to remember this may not be a desired result for a settlor who values equality over efficiency or fixed over variable income patterns.

- **Use Portability Effectively.** Decedents who create A/B or by-pass trusts in their will may want to ensure that any by-pass trust pays out all or most of its income. By-pass trusts are subject to the §1411 tax if their income reaches the minimum tax threshold. However, it may not always be feasible to distribute all trust income. Therefore, testators may prefer to rely on portability, rather than an A/B trust format, to ensure their assets are transferred at low federal estate tax rates and also avoid generating income subject to the §1411 tax. Although this may cause the surviving spouse to have additional investment income on any investments made with these assets, the new threshold for that income will be raised to $200,000.

- **Consider Tax Efficient Trusts.** Both grantor trusts and charitable trusts (such as charitable remainder trusts) are not subject to the §1411 tax and, therefore, can be useful tools in planning around the 3.8% tax. In the case of a grantor trust, provided the relevant grantor trust rules are followed, any trust income attributed to the trust becomes the obligation of the grantor. Therefore, whether the §1411 tax applies to NII depends on the grantor's MAGI. Again, this may not result in any tax savings if the grantor has significant income. However, even in those situations, grantor trusts may be useful, as they allow the grantor to pass additional wealth to beneficiaries (in the form of paying tax on the beneficiaries' income) without being subject to additional gift tax. For individuals who are charitably minded, the use of certain charitable trusts will also help them avoid additional income tax payments. However, NII that is distributed to a non-charitable beneficiary as part of any annuity or unitrust distribution may be taxed as NII in the hands of the beneficiary.

- **Adjust Investment Portfolio.** Aside from altering the timing of distributions and the type of trust structure involved, another useful way to reduce additional income tax within a trust or estate is to utilize an investment portfolio

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The Real World Consequences of Federal Budget Cuts

By RONALD N. LEBOVITS
ZARWIN, BAUM, DEVITO, KAPLAN, SCHAER, TODDY, P.C.

As our national leaders grapple with crucial budget issues, it is likely that government spending for so-called "entitlement" programs will decrease, probably in significant amounts. Automatic spending cuts mandated by sequestration have already taken effect and will certainly force significant budget cuts unless corrected by Congressional action. Many entitlement programs provided at the state and local levels are, in reality, funded by the Federal government. The inevitability of funding reductions is harrowing for anyone whose loved ones live in a nursing home or similar institution -- whether the children of elderly parents or the parents of children with intellectual disabilities, such as Autism. Important issues are also raised for attorneys who practice in the areas of Trusts and Estates.

Elderly nursing home residents who suffer from dementia as well as persons with intellectual disabilities, including those with autism, are uncommonly vulnerable to neglect and abuse, including physical and sexual assaults, in large part because they are unable to speak out and unable, in some instances, to even understand that they are being mistreated. As government funding decreases and caregivers are fewer in number, paid less, and under greater stress, it is likely that incidents of neglect and abuse will increase. It is therefore necessary to re-examine the types of actions and inactions that constitute neglect and abuse. Likewise, it is crucial that we explore the signs that might indicate any sort of mistreatment, especially when the victims are unable to communicate in traditional ways. Lastly, families and institutions need to discuss the remedies and options that are available when acts of neglect and abuse occur.

Whether set by statute or more generically defined, the concept of neglect usually refers to the failure of a responsible caregiver to deliver resources, services or treatment to a care dependent person who requires those resources, services or treatment to address his or her basic care needs. For example, Title 18 Pa. C.S.A. Section 2713 creates criminal penalties for a caretaker who –

Intentionally, knowingly or recklessly causes bodily injury or serious bodily injury by failing to provide treatment, care, goods or services necessary to preserve the health, safety or welfare of a care-dependent person for whom he is responsible to provide care.

Most people readily understand such definitions to ensure the delivery of food, water, clothing, shelter or medication. But the concept of neglect is broader. It also includes the duty to provide supervision and protection for a care dependent person who is unable to exercise sound judgment and/or unable to safely perform an activity of daily living for himself or herself.

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Playing by New Rules, continued

that will limit the amount of tax incurred, even on undistributed income. Fiduciaries that wish to reduce income tax burdens should consider making tax-efficient investments, such as tax-exempt bonds, that will greatly reduce or eliminate additional tax, even for trusts and estates with income well above the threshold limits. Additionally, fiduciaries should also consider making fewer investments with high interest or dividend payments and instead make investments that favor growth and long-term capital gains. In some ways, this is merely a deferral tactic – trusts or estates will still need to recognize any capital gains incurred when the asset is sold (though possibly at a far lower rate than non-capital gain income). It should be noted that although capital gains are typically not considered "income" to a trust or estate, capital gains fit within the definition of NII under the "transfer of property," and therefore any capital gain within a trust or estate will still be subject to the 3.8% tax. A possible solution to this problem is for fiduciaries to distribute appreciated assets to beneficiaries directly rather than sell the asset and pass the proceeds to the beneficiary. This may subject the beneficiary to taxes upon the sale of the asset, but perhaps at a lower rate.

Federal Budget Cuts, continued

For example, many individuals with impaired judgment and/or impaired physical abilities are at risk of elopement away from a safe environment and into dangerous locations such as a busy roadway. They must, therefore, be supervised at all times and the failure to do so can constitute neglect. Wherever the need for supervision and assistance is present - in feeding, toileting, bathing and recreational activities - the risk of neglect exists. Depending upon the overall physical well being of the care dependent person, neglect can also arise with issues such as fall prevention, smoking, eating or pressure ulcers. Pressure ulcers, in particular, can necessitate amputations and even cause death. Unsupervised smokers can set themselves – and their residences – on fire. Chewing impaired residents can choke to death when given the wrong food texture.

In contrast, wherever the term is used, abuse is commonly defined to constitute deliberate acts committed by a care giver upon a care dependent person that causes physical and/or emotional harm, such as physical, sexual, verbal and/or emotional assaults, such as in the Pennsylvania Older Adults Protective Services Act. Acts of abuse can also include the inappropriate use of physical or chemical restraints. Additionally, isolating a care dependent person by restricting contact with family or placing a care dependent person to remain in a bedroom is a form of abuse.

Recognizing obvious neglect or obvious abuse is relatively simple. Most reasonably observant persons who have regular, consistent interaction with a care dependent person will fairly easily take notice of malnutrition, dehydration, bruises and cuts that are out of the ordinary. Unfortunately, not all signs of neglect and abuse are clear and obvious. Moreover, care dependent persons are often unable to communicate their problems and may exhibit a host of maladaptive behaviors (an inherent part of their underlying cognitive problems) which conceal or otherwise make it difficult to identify the expressions of distress in response to abuse or neglect.

There is no single, simple answer to such a situation. However, it is possible to identify signs of neglect and abuse. In general, a change in overall emotional affect, as with anyone, might arise from trauma or distress. An increase in the frequency or intensity of self-injurious behaviors and/or a change in the time of day when self-injurious behaviors occur can indicate a change in the environment of a care dependent person that has caused him or her distress. Avoidance of a care giver or housemate can signify conflict. Likewise, agitation in the presence of a care giver or housemate can signal a problem.

When neglect or abuse occur, it is obviously imperative to correct the underlying problem itself in a fashion that causes no further trauma. If not handled properly, the correction can inflict as much harm as the neglect and abuse previously committed. This is particularly true with individuals who have, as part of their cluster of symptoms, a strong need for sameness. Any change in a person's environment or routine, even if intended to be protective, can in itself be very distressing.

Attorneys can play a crucial role in the process of identifying and correcting abuse and neglect. Many attorneys have the privilege to represent care dependent persons or to otherwise look after their interests. In some instances, attorneys are appointed to serve as guardians of care dependent persons and are required to complete and submit periodic reports to the Court addressing the client's status, condition and well-being. Such attorney/guardians arguably have a fiduciary duty to take steps to identify the neglect and bring it to an end.

In other instances, attorneys meet with family members to probate a will or open an Estate after the avoidable death of a care dependant person. In such settings, families report and/or death certificates disclose reasons to believe the neglect or abuse contributed to the decedent's death. Legal claims arising from neglect and abuse are assets of the Estate which can be pursued for the benefit of the heirs. The duly appointed representative of the decedent's Estate is arguably obligated to investigate and prosecute any potential legal claims arising from neglect or abuse.

Depending upon where an attorney becomes involved in the process, there are important steps we can take, whether as a counselor or advocate for a victim or for the surviving family members. It is essential to make sure that the victim of the neglect or abuse receives assessments and therapy designed to identify and treat any physical or emotional consequences arising from the neglect or abuse. In addition to the needs of the victim, it is necessary for the facility or institution where the neglect or abuse took place to conduct a thorough, objective investigation of the facts and circumstances which allowed or caused the neglect or abuse to occur. Once understood, it is necessary for the facility or institution to undertake and implement corrective measures to minimize the risk that such abuse or neglect will occur again, including as appropriate additional training for staff members, development of policies and procedures and perhaps

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even changes in personnel. Lastly, there might be some situations when the victims of neglect and abuse need to pursue remedies and compensation through the judicial system.

Reductions in government spending are likely to have profound effects upon clients represented by Trust and Estates attorneys, both directly and indirectly. It is imperative that we understand the full scope of those consequences so that we can represent our clients to the best of our abilities.

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ED. NOTE: Ronald N. Lebovits is a partner at Zarwin Baum, where he leads the firm's elder abuse and neglect division. Since May of 1998, he has exclusively represented the victims of nursing home neglect and abuse, successfully prosecuting civil lawsuits against nursing homes, personal care homes, assisted living facilities, community based homes for persons with developmental disabilities and hospitals. His cases have involved instances where residents or patients have experienced physical abuse, developed severe yet avoidable pressure sores, suffered preventable falls, or choked on their food, among other examples of poor care. You can contact Mr. Lebovits at 215-569-2800, extension 1104, or by email at Rlebovits@Zarwin.com.

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The Section's Committees depend on the steady flow of people, energy and ideas. Join one! Fill in the form below and send it to the Section Chair:

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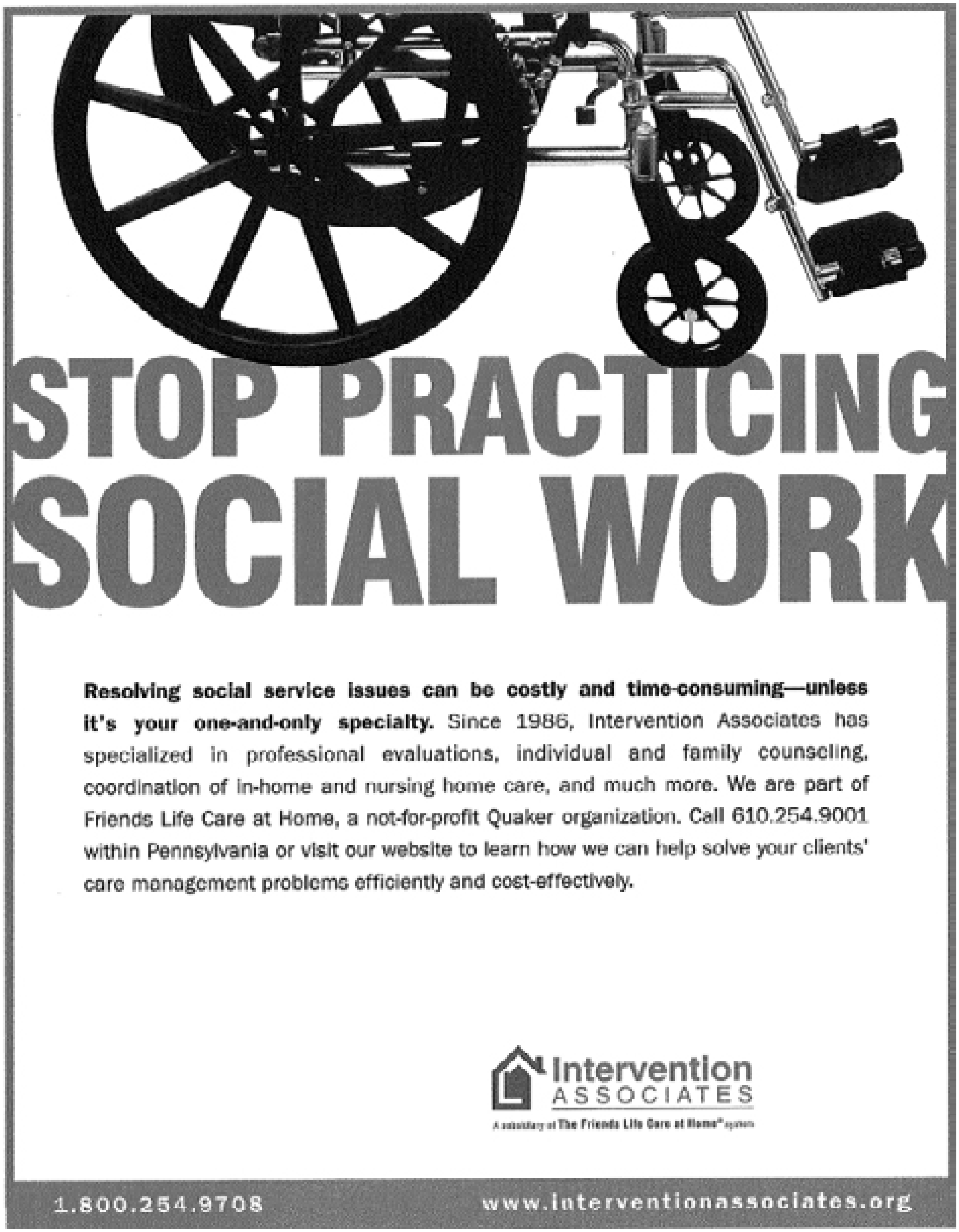

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CASE SUMMARY FROM THE ORPHANS' COURT LITIGATION COMMITTEE

Cohen Estate, 3 Fid. Rep. 3d 145 (O.C. Bucks 2012)

By TIMOTHY J. HOLMAN, ESQUIRE, AND DANIEL R. BOOSE, ESQUIRE
SMITH KANE, LLC

In a will contest matter, the parties and the Court focus on the Decedent's intent. For example, did the Decedent actually intend to sign a will leaving everything to one child to the exclusion of all others, or did that will result from the exertion of undue influence upon the Decedent by the child who received the entire estate?

To get to the bottom of things, the parties engage in discovery designed to investigate the circumstances surrounding the preparation and the execution of the will at issue. In cases involving a will prepared by a lawyer, the one person who should surely know what the Decedent intended is the lawyer who prepared the will. If that lawyer is a good lawyer, then his or her file should contain notes regarding the lawyer's discussions and meetings with the client about the terms of the will. Indeed, when a testator "cuts out" one or more family members in favor of others, a good estate planning lawyer will know that a will contest may likely arise when the testator dies, and the file will contain notes confirming that the lawyer explained that to the testator, and documenting the reasons for the disparate treatment. Indeed, a good estate planning attorney should document the client's decision to treat family members (or anyone else who might reasonably have been expecting to receive a bequest under the will) disparately in a letter to the client. Such notes and correspondence will presumably detail the reason(s) why the testator was determined to leave nothing (or a token gift) to those who might otherwise have expected a share equal to others. The lawyer's file will typically contain other helpful information, such as drafts of wills, which may show a progression of changes to the will from the initial meeting through execution.

Given the bounty of information contained therein (or the bounty of cross-examination which will result if the scrivener's file is awfully thin and lacks any real explanation for the will at issue), lawyers who practice in this field typically turn immediately to the scrivener of the will and ask that the lawyer produce his or her file to counsel. What about the attorney-client privilege, though? Doesn't the attorney-client privilege keep what we have told our attorneys secret even after we have died? How about the attorney work product doctrine, which generally protects materials or documents prepared by counsel on behalf of their clients? In the world outside of will contests, those privileges present substantial hurdles to anyone seeking to access to your lawyer's file, even after you have died. In the context of a will contest action, however, that file must be produced. A recent opinion by Judge Gilman of the Bucks County Court of Common Pleas, Orphans' Court Division, explains why.

Cohen Estate, 3 Fid. Rep. 3d 145 (O.C. Bucks 2012), is a will contest action in which the contestants allege that the Decedent executed the will at issue as the result of undue influence. The Decedent in *Cohen* lived with his nephew between May of 2006 and his death on June 4, 2009. At the time he moved in with his nephew, Decedent executed a power of attorney naming his nephew as agent, with full control and authority over his assets. Prior to executing that power of attorney, Decedent had never executed any testamentary writings. The record revealed that Decedent's nephew contacted and retained a lawyer to prepare three separate wills for Decedent, all of which left a "substantial bulk" of Decedent's estate to the nephew. The disappointed family members, who received little or nothing under Decedent's will as probated, contested the will as the product of undue influence by the nephew.

During the litigation, the disappointed heirs subpoenaed the scrivener's records, but the scrivener objected to producing the file, citing the attorney/client privilege and work product doctrine. In rejecting those objections and ordering the scrivener to produce the file to contestants' counsel, Judge Gilman emphasized that the materials presumably contained within the scrivener's file were highly relevant to the issues presented by the matter. Judge Gilman noted that the file might well contain notes about Decedent's capacity, competence, intent, independence of thought, and testamentary

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Case Summary, continued

capacity.

Judge Gilman next turned to *In Re: Thevaos Estate*, 10 Pa. D.&.C. 5th 481 (O.C. Centre, 2010), which held that applying a testamentary exception to the attorney/client privilege is proper when the deceased holder of the privilege may have been unduly influenced. The Court concluded that discovery of the scrivener's file may either eliminate or affirm concern about undue influence, while also shedding light on the relevant history of Decedent's testamentary changes (which would shed light on Decedent's intent). The Court further noted that the file would presumably help the parties and the Court determine whether Decedent was capable of clearly communicating that intent.

In His Honor's discussion of the testamentary exception, Judge Gilman also turned to the Supreme Court opinion, *Swidler & Berlin v. United States*, 524 U.S. 399 (1998). In *Swidler*, the United States Supreme Court noted that the disclosure of attorney/client communications regarding testamentary matters furthered the client's intent in litigation between the testator's heirs. The Supreme Court therefore held that the attorney/client privilege could be impliedly waived in order to fulfill the client's intent, and that the testamentary exception was the appropriate mechanism for assisting the parties in establishing Decedent's intent. See also *Glover v. Patten*, 165 U.S. 394, 406-408 (1897).

As a secondary argument against the production of any portion of the scrivener's file, the scrivener argued that the Orphans' Court should, at a minimum, conduct an in camera review of the file (i.e. the Judge should read the entire file himself) before ordering the production of its contents. Judge Gilman wisely rejected that argument, and stated that an in camera review was both unnecessary and inefficient because the subject matter of the subpoena was so directly tied to the facts of the will contest cause of action. In other words, the purpose of an in camera review (a remedy granted rather infrequently by any court) is to ensure that irrelevant/possibly prejudicial information is not disclosed unless a judge first reviews the materials for their relevance, but Judge Gilman concluded that the estate planning file could not conceivably contain information irrelevant to litigation involving that very estate plan. As such, and although Judge Gilman did not state it this bluntly, a review of the file by the Court would be an utter waste of the Court's time.

Counsel who practice regularly in will contest matters know that the scrivener's file is "Exhibit A" in a will contest. Not all scriveners, however, understand the law governing will contest actions, and scriveners often reflexively invoke the attorney/client privilege or work product doctrine when asked to produce their files. *Cohen Estate* will serve as a helpful guide to all practitioners and scriveners on this important issue.

NEWSLETTER ARTICLES

Would you like to see something in future issues of the Probate and Trust Law Section Newsletter? Then, why don't you write it? If you are interested, please contact the Editor:

David A. Ruben
email: davidaruben@gmail.com

Practice Points

BY BERNICE J. KOPLIN, ESQUIRE
SCHACHTEL, GERSTLEY, LEVINE & KOPLIN, P.C.

Issues such as whether a document is an original or copy of a Will, difficulty obtaining a death certificate or other information, and payment of fees frequently arise at the opening of an estate at the Office of the Register of Wills. The following pointers are intended to be helpful in this regard:

Payment of Fees. The Office of the Register of Wills has signs on the wall of its offices, and in its website that effective Thursday, November 1, 2012, the Register of Wills ceased accepting personal checks. Money orders and some credit cards and are accepted, such as Visa and Mastercard. A reason for the new policy is that personal checks sometimes bounced, in which event collection of the funds was made costly and inconvenient for the office.

Difficulty of Determining Original from Copy of Last Will and Testament. Some Wills are now emailed to clients, who print them on white bond paper, and execute them using black ink. Thus no red lines adorn the heavyweight paper and no blue ink indicates an original. Now that copies are much improved, it can be difficult for the Register's office to tell whether a specific document is an original or a copy. In such instances, many attorneys have filed a petition to probate the copy as an original (see Blue Book). But John F. Raimondi, Esquire, Litigation Deputy in the Register of Wills office, has indicated that the Office would accept a letter from scrivener-counsel that a specific Will is an original, thus eliminating the need for a hearing on the matter.

Difficulty Obtaining Death Certificate or Other Information Needed for Probate. The Register of Wills office has indicated that it will issue or execute a subpoena for information needed for probate, if contacted by counsel, in matters where those who have the information are being uncooperative in providing it.

* * * * * * * * *

ED. NOTE: Readers are encouraged to send their questions or ideas for consideration in future issues to Bernice J. Koplin at bjkoplin@sglk.com.

Volunteer for Philadelphia VIP

Philadelphia VIP serves as the hub of pro bono civil legal services in Philadelphia. VIP is in need of volunteer attorneys for a few types of cases particularly well suited to members of the Probate and Trust Law Section: "tangled title" cases, where clients are living in homes they have inherited from a deceased relative but to which they do not have legal title; uncontested guardianships of family members; and estate planning for clients who own real property or are in declining health.

VIP is in need of volunteer attorneys to continue to serve these clients, both to represent clients and to serve as mentors to volunteer attorneys who are new to this area of practice.

If you are able to volunteer in any capacity, please contact Kelly J. Gastley, Supervising Attorney at VIP, at (215) 523-9566 or kgastley@phillyvip.org.

ETHICS COLUMN

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

Is it true that I may have to report a client that I find is involved in money laundering or funding terrorist activities? If so, what application do the principles of confidentiality and attorney-client privilege have?

Fortunately, in the United States, the principles of client confidentiality still apply and the ethical lawyer need look no further than the Rules of Professional Conduct to determine the options available in the face of such discovery. However, that is not true in a growing part of the world. In the United Kingdom, for instance, the lawyer (Solicitor) is obligated to report such client activity and, of even greater moment, must not notify the client that he or she has made a report.

This law in the United Kingdom grows out of the brainchild known as the Financial Action Task Force ("FATF") established in 1989 by the G-7 Nations (U.S., U.K., Germany, France, Italy, Japan and Canada), the European Commission and eight other countries. After the September 11th terrorist attacks, the FATF recommendations were augmented by anti-terrorist provisions and now the FATF recommendations are the international standards for combatting money laundering and terrorist financing. Today, the FATF enforcement process works through international peer pressure and, as of a year ago, there were 36 FATF member countries.

This movement has been motivated by the massive and growing international problem of money laundering and terrorist financing activity. Although not obligated to do so, many countries have passed legislation to help enforce the FATF principles. The Bank Secrecy Act as amended by the U.S. Patriot Act here in the U.S. is one example. Lawyers who have helped clients open bank, brokerage and money management accounts in recent years have seen the results: Complicated and onerous applications with quite intrusive questions.

What is now concerning U.S. lawyers is the shifting focus of attention internationally to all "gatekeepers" to the financial system: People and entities that can facilitate such activities. They wish to include lawyers in that category, particularly transactional lawyers, who handle real estate transactions, and form entities such as corporations, LLCs and trusts. We trust and estate lawyers are beginning to attract particular scrutiny internationally because so few countries understand or make use of trusts and in those countries that do, trusts are often associated with obfuscation and tax dodging.

The concern that U.S. lawyers may be subject to unwelcome legislation is not borne of mere paranoia. As noted before, Solicitors in the United Kingdom are required to file "Suspicious Activity Reports" about their clients and are prohibited from tipping off clients that the report has been filed.

In an effort to avoid Federal legislation that would govern lawyers' reporting practices, as they do in the United Kingdom, representatives of the American Bar Association and other national organizations, including The American College of Trust and Estate Counsel, The American College of Real Estate Lawyers, The American College of Mortgage Attorneys and The American College of Commercial Finance Lawyers, prepared what is known as "Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing". The practices, simply called "Good Practices Guidance" were issued on April 23, 2010. The 39-page document provides excellent tips on spotting red flags during the intake process that the Guidelines call "client due diligence". In brief, they encourage the lawyer to focus on risk categories such as country risk, client risk and service risk, to analyze where the client may have obtained the money, the nature of the client, what the client intends to do with the money, and what the lawyer's role will be in the client's plans.

To further emphasize the Good Practices Guidance and the need for lawyers to see them in the context of ethical practices, the ABA adopted formal Ethics Opinion 463 on May 23, 2013. The opinion says that: "By implementing the risk-based control measures detailed in the Good Practices Guidance where

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Ethics Column, continued

appropriate, lawyers can avoid aiding illegal activities in a manner consistent with the Model Rules."

The ABA opinion makes it clear that lawyers are neither requested to consider themselves "gate keepers" nor expected to follow any rules-based approach. It simply stresses that it would be prudent for lawyers to undertake CDD during the intake process while providing services in accordance with the guidelines detailed by FATF. The Good Practices Guidance "urges lawyers to assess money-laundering and terrorist financing risks by examining the nature of the legal work involved and where the business is taking place." As the ABA notes, this is consistent with ABA Informal Opinion 1470 (1981) that basically opined that "(a) a lawyer cannot escape responsibility by avoiding inquiry. A lawyer must be satisfied, on the facts before him and readily available to him, that he can perform the requested services without abetting fraudulent or criminal conduct and without relying on past client crime or fraud to achieve results the client now wants."

We trust and estate lawyers have two very good reasons to become familiar with and follow the Good Practices Guidance: None of us wishes to be swept up in anything illegal nor do we want Federal legislation to impose mandatory reporting of clients and the total abrogation of Rules of Confidentiality (Rules 1.6 and 1.18) and to report clients without their consent contrary to Rule 1.4(a)(5).

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

Send your questions and ideas to:

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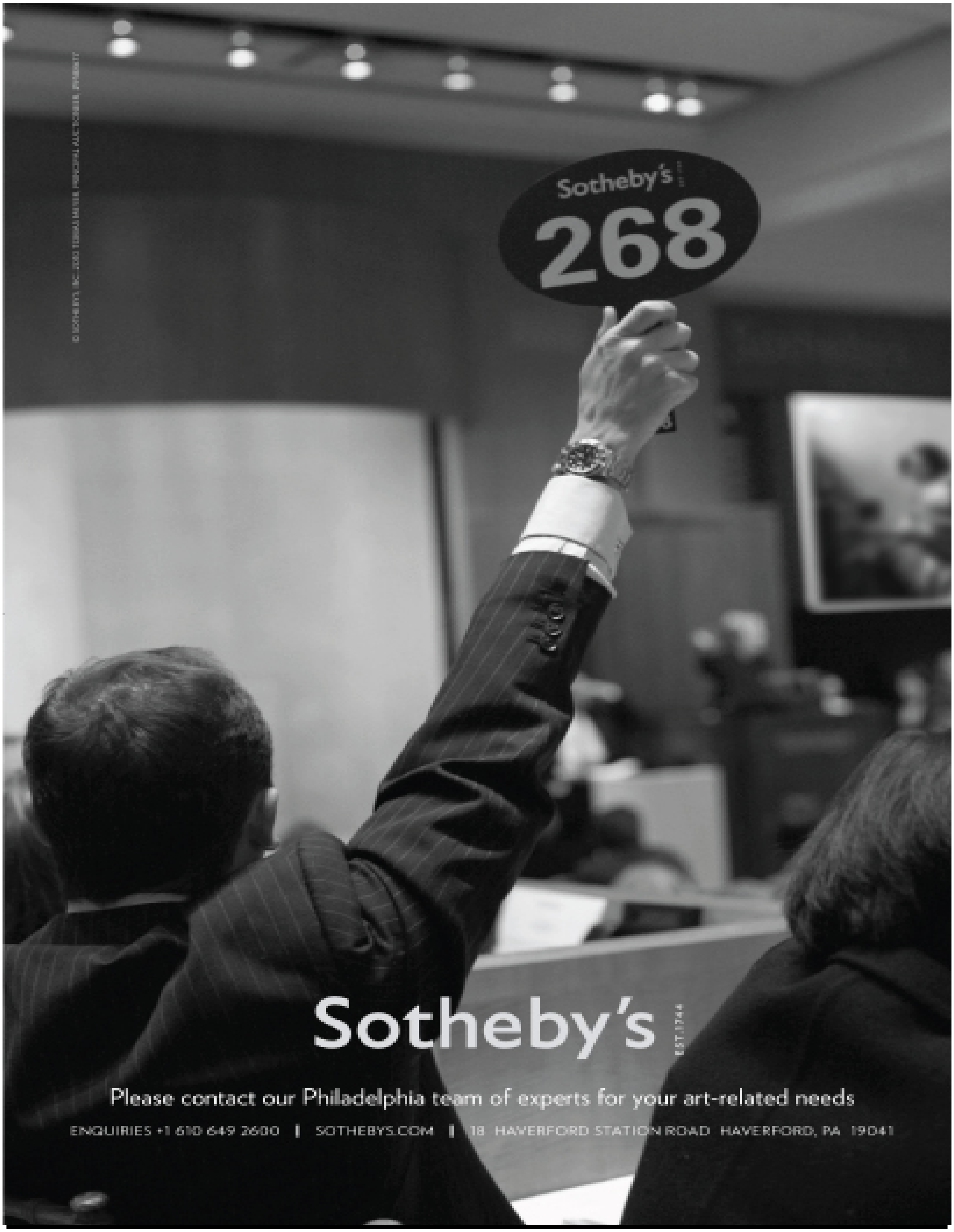
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TAX UPDATE

By MARGERY J. SCHNEIDER, ESQ.
ROSENN JENKINS & GREENWALD, LLP

FEDERAL ESTATE TAX

Valuation

Estate of Elkins v. Commissioner, 140 T.C. No. 5 (March 11, 2013).

At the time of his death, Mr. Elkins held undivided fractional interests in sixty-one works of art in a grantor-retained income trust. His children had been gifted the remaining interests by his wife, who had predeceased him, subject to a co-tenancy agreement requiring unanimous consent for the sale of any pieces in the collection. The taxpayer's estate claimed a 44.75% discount for lack of control and lack of marketability, but the Court found that under IRC § 2703(a)(2) the restrictions on the sale of the artwork could not be taken into account in valuation. Although the Court affirmed that a decedent's undivided fractional interest in artwork may be discounted from the fair market value for estate tax purposes, it allowed a discount of only 10%, reasoning that the decedent's children were likely to seek to buy back any fractional interests purchased by a hypothetical buyer.

Estate of Koons v. Commissioner, T.C. Memo 2013-94 (April 9, 2013).

The Tax Court ruled on two issues in this case: first, whether the estate of John F. Koons, III, the scion of a Cincinnati brewing company operated as an LLC ("CI LLC"), was entitled to a deduction of approximately $71 million in interest on a $10.75 million Graegin loan from the decedent's revocable trust; and second, the appropriate valuation discount for CI LLC.

On the first issue, the Court ruled that the estate was not permitted to deduct the interest from the value of the gross estate. The Court found that the loan was not deductible because it was not an "essential" expense of the estate, as that term is defined in Treas. Reg. 20.2053-3(a). Although the decedent died in 2005, the terms of the loan forbad prepayment and called for installment payments of interest and principal to be deferred until 2024. The Court found that the estate, which held a 70.42% voting interest in the LLC, which had more than $200 million in liquid assets, could have required the LLC to use its existing assets to make distributions to pay the estate tax.

On the second issue, the Court agreed with the IRS's 7.5 percent discount for lack of marketability and not the estate's 31.7 percent discount for lack of control and lack of marketability. The estate's valuation discount was based on published research on active business operations, whereas the IRS claimed that a hypothetical buyer would be likely to base his or her pricing decision on the fact that the LLC held mostly cash.

Estate Tax Return Filing Penalty

Knappe v. United States, No. 10-56904 (9th Cir., April 4, 2013).

The appellant, the executor of an estate, relied on his accountant's assurance that he had obtained a one-year extension of the filing due date from the IRS to file the estate's Federal Estate Tax return. In fact, the deadline had been extended for only six months. As a result, the executor was held liable for a large penalty for late filing. The executor argued that his reliance on the advice of an expert gave him reasonable cause for the late filing

The Central District of California granted the government's request for summary judgment (No. 2:09-cv-07328-DMG-PJW (C.D. Cal. 10/22/10), ruling that the late filing penalty was applicable as a matter of law and the executor could not show reasonable cause to excuse the penalty. The Ninth Circuit affirmed the penalty, citing the Supreme Court's decision in *Boyle*, 469 U.S. 241) to explain that there is a distinction between an executor's reliance on an expert's advice about whether a return is due and the executor's duty to ascertain the correct deadline for filing a tax return. Reliance on an expert's erroneous advice about whether a return is due requires advice on a matter of law. "When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice." In contrast, for an executor to rely on an expert's erroneous advice about a filing deadline demonstrates the executor's failure to "exercise ordinary business care and prudence," because he or she is easily able to ascertain the correct filing deadline himself.

As a further rationale for affirming the penalty, however burdensome this holding might be on executors, the court commented that to hold otherwise would "reward

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Tax Update, continued

collusion between culpable executors and their agents. In cases like this one, lawyers and accountants would be incentivized to claim that they gave erroneous advice to the executor whether or not they did in fact. The agent who fell on his sword would risk nothing, because the waiver of the penalty would leave the executor without damages."

Grandfathered Buy-Sell Agreements

Private Letter Ruling 201313001

Agreements entered into prior to October 8, 1990 and that have not been "substantially modified" after that date are not subject to the restrictions placed by IRC §2703 on the ability of a buy-sell agreement to control estate tax values in a closely held entity. Treas. Regs. §25.2703-1(c) defines the term "substantial modification" for this purpose. In the case of the buy-sell agreement in question, the IRS stated that modifications to extend the repayment terms and to clarify the definition of prime rate were not considered substantial modifications.

FEDERAL GIFT TAX

Completed Gifts

Estate of Sommers v. Commissioner, T.C. Memo. 2013-8 (January 10, 2013).

The Tax Court was asked to rule whether a decedent, who died on November 1, 2002, made completed gifts of interests in an LLC in late 2001 and early 2002, as the IRS claimed, or whether he retained the power to "alter, amend, revoke or terminate" those transfers until he relinquished that power several months later. If the latter, the earlier transfers would not be considered taxable gifts and their value would be included in the decedent's gross estate under IRC Sections 2035 and 2038(a)(1).

In late 2001, the year before his death, the decedent, a physician and art collector, transferred twelve pieces of artwork valued at $1.75 million to an LLC, then transferred all of the units of the LLC to his nieces. Each niece held a minority interest in the LLC, whose terms called for transfer restrictions. The transfer restrictions and minority interest allowed for a discount for gift tax purposes. For gift tax planning purposes, the number of LLC units to be transferred to each niece was left blank on the gifting documents.

The decedent later changed his mind about making the gifts. His estate argued that the blanks left in the documents gave him the § 2038(a)(1) power to "alter, amend, revoke or terminate" the gifts, which he relinquished a few months later. Because the decedent died within three years of relinquishing that power, the estate argued that the LLC units were thus includible in his estate under IRC § 2035(a) and are not subject to Federal gift tax.

The IRS argued, and the Court agreed, that, because the gifts were considered valid and irrevocable under New Jersey and Indiana law, the gifts were completed gifts and the decedent was collaterally estopped from arguing that the gifts were not gifts for Federal tax purposes.

Private Annuities

Estate of Kite v. Commissioner, T.C. Memo. 2013-43 (February 7, 2013).

In this complex case, the Tax Court ruled that deferred private annuities were not "disguised gifts," in and of themselves, but that the value of the deferred private annuity contracts that was traceable to two QTIP trusts should be treated as a taxable gift for purposes of IRC § 2519.

In 1997, a family limited partnership ("Baldwin") was created by five trusts of which the Mrs. Kite was a beneficiary. Four of the trusts consisted of the proceeds of her deceased husband's estate: two QTIP trusts, one general power marital trust and a residuary trust. The fifth trust was Mrs. Kite's own revocable trust. Mrs. Kite, as trustee, then made gifts to her three children of approximately one-third of her limited partnership interests and some of the stock of the corporate general partner and paid gift taxes on the discounted value of the gift. The next year, the trusts sold their remaining limited partnership interests to the children in exchange for secured recourse promissory notes. Two years later, the trusts contributed their interests in the notes to a newly formed general partnership. The children, who had been substituted as trustees of the two QTIP trusts and the marital trust, terminated the three trusts and distributed their assets to Mrs. Kite's revocable trust, which then held all of the interests in the general partnership. On March 30, 2001, the revocable trust sold its interests in the general partnership to the children in exchange for ten-year deferred private annuity agreements. The children were to begin payments to Mrs. Kite or her trusts ten years after the effective date of the private annuity agreements. If she died on or before March 30, 2011, no payments would be due and the property exchanged for the annuity would not be taxable in her estate. If she survived the deferral period, the children would each be personally liable for annuity payments of $1,900,679.34. Mrs. Kite died in 2004, at which time the annuities became worthless. The in-

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terests transferred to the children were not reported as part of her estate or among her taxable gifts.

The IRS assessed deficiencies on the estate tax return and with respect to the unreported gifts. It claimed that the annuity agreements were a "disguised gift," arguing that the annuity agreements did not represent adequate consideration because Mrs. Kite was ill at the time of the transfer, the annuities "were structured to ensure that no annuity payment would be made and there was no real expectation of payment." The estate countered, citing Reg. Sec. 1.7520-3(b)(3), that the IRS actuarial tables that were properly used to value the annuities stated that Mrs. Kite, who at the time of the agreements was 75 years old, had a life expectation of 12.5 years. Mrs. Kite had obtained a physician's certification that she had at least a 50 percent probability of surviving 18 months or longer. The Tax Court upheld the annuity transactions, stating that they constituted a bona fide sale for full and adequate consideration and that the transaction had economic substance. The Court also rejected the argument that the children did not expect to pay the annuities and that their assets were insufficient to make the annuity payments.

However, the Court upheld the Commissioner's claim that the termination of the QTIP trusts constituted a disposition of Mrs. Kite's interests under IRC § 2519, and ruled that the value of the deferred annuity contracts that was traceable to the interests of the QTIP trusts in the general partnership, minus the then present value of Mrs. Kite's qualifying income interest in the trusts, must be treated as a taxable gift. The Court held that the transfer of the assets of the non-QTIP marital trust to the revocable trust did not constitute the release by Mrs. Kite of her general power of appointment because those assets were distributed to a trust o which she was the sole beneficiary during her lifetime.

GREEN BOOK: FISCAL YEAR 2014 BUDGET PROPOSAL

The federal budget proposals for fiscal year 2014 released by President Obama on April 10, 2013 contain the following estate and gift tax proposals:

- As of 2018, the 2009 Transfer Tax rates and exemption amounts would return, with a top 45% estate, gift and GST tax rate, exemptions of $3.5 million for estate and GST tax, and $1 million for gift tax. No adjustments would be made for inflation.

- GRATs would be required to have a minimum term of 10 years and a maximum term of the life expectancy of the annuitant plus ten years. Also, all GRATs would need have a remainder interest value greater than zero at the time the interest is created.

- The GST exclusion allocated to a trust would terminate on the 90th anniversary of the creation of the trust. This would apply to any portion of a trust created after the enactment date.

- The income and transfer tax rules applicable to grantor trusts would be coordinated.

- The exclusion from the definition of a GST transaction under IRC § 2611(b)(1) would be defined to apply only to a payments made directly to the provider of medical care or to a school in payment of tuition and not to trust distributions, even if made for the same purposes.

The PEPC invites the Philadelphia Bar Association Probate and Trust Law Section to join our Council for membership and programming!

September Luncheon Program
September 17, 2013
11:45 a.m. - 1:45 p.m.
The Union League
140 S. Broad Street, Philadelphia, PA
Speaker: Robert S. Keebler, CPA, MST, AEP

October Luncheon Program
October 15, 2013
11:45 a.m. - 1:45 p.m.
The Union League
140 S. Broad Street, Philadelphia, PA
Topic: "What you say to your client…What they hear"
Speaker: Jean Chatzky

November Luncheon Program
November 19,2013
11:45 a.m. - 1:45 p.m.
The Union League
140 S. Broad Street, Philadelphia, PA
Topic: "Trends in Philanthropy"
Speaker: Doug Bauer

For more information on joining the Philadelphia Estate Planning Council or to register for any upcoming programs, please visit www.philaepc.org.