Report of the Chair

By NORMAN E. DONOGHUE, II
DECHERT

The year 2002, the Bicentennial Year for the Philadelphia Bar Association, has seen the Section’s activities get off to a fast start since Chip Harvey literally handed off the “baton” to me at the Annual Meeting in December.

With the help of fellow officers Howard Verbofsky (Chair Elect), Marilyn Sanborne (Vice Chair) and Julia Fisher (Secretary), we quickly lined up the 2002 Roster of personnel and the calendar of monthly events.

Appointments included:
Young Lawyers Division representative - Tom Hiscott
5-County Effort - Margaret Sager
PBA Strategic Planning Comm. - Jack Terrill
Chancellor’s Appointment to Exec. Comm. - Ed Kaier
Board of Governors representative - Howard Verbofsky
Tax Section Liaison - Bernice Koplin
Professional Responsibility Committee - Rob Friedman is our representative this year looking into a study of ethical issues in multi-jurisdictional practice

Next we asked for a status report on the “Green Book.” This project is truly nearing completion under Ad Hoc Chair Daphne Goldman and the trio of Senior Editors Gene Gillin, Ralph Teeters and George Forde. This effort represents several years of hard work by many Section members. The completion of this project can be our bicentennial gift to our corner of Philadelphia law practice!

So, too, the Section has been working closely for the past year with Orphans’ Court Division Administrative Judge, Joseph J. O’Keefe. The officers were invited to his chambers in January to talk about continuing the various projects we have underway to improve the administration of justice in our corner of the Philadelphia legal world. We both gave and received evidence of continuing cooperation to find ways to serve both the practitioners and the public with redoubled dedication. Local rules, website additions, address lists and many other topics focused our joint attention. If you have ideas of where we can improve the administration of justice, please bring them to my or another officer’s attention. We have a unique opportunity at this time to accomplish such objectives.

continued on page 25

Inside this Issue....

Drafting Under the 2001 Act..........................3
Superior Court Provides Guidance on What Constitutes a “Confidential Relationship”......14
Ethics Column........................................15
Tax Update..........................................17
Philadelphia Orphans’ Court Forms Now on Court Website..........................22
Update: Pennsylvania’s New Section 529 Plan..................................23
Tax Committee Meetings of October and December 2001.................24
Section Events Calendar...............................25
Trust in Teamwork

There's no substitute for the security of knowing that your financial interests are being managed by a professional team that understands your goals and is committed to responsive, individualized service.

Working together, we work with you. As trustee, executor, guardian or advisor, our Trust team will map a strategy, pursue your objectives and safeguard your wealth. Our combination of fiduciary skills and investment sophistication relieve you of the burdens of managing wealth today while preserving it for future generations.

The Pennsylvania Trust Company. Teamwork you can trust.

To discuss your objectives, please call Kathleen F. Freed at 610.975.4300
Five Radnor Corporate Center Suite 450 Radnor, PA 19087 www.penntrust.com
Drafting Under the 2001 Tax Act

By ROBERTA BARSOTTI
HECKSCHER, TEillon, TERRILL & SAGER

On Friday, March 1, 2002, a group of Philadelphia estates law practitioners met to discuss informally their reactions to the scheduled repeal of the federal estate tax. For about an hour, Daniel Evans ("DE"), Robert Freedman ("RF"), Daniel Ross ("DR") and Cliff Schlesinger ("CS") shared opinions and exchanged ideas about how and how much the scheduled changes to the federal estate tax are affecting their approach to estate planning. As moderator, I posed some questions, and the panel took it from there.

Moderator: What odds do you give full repeal of the federal estate tax, and its replacement with the new basis rules under IRC §1022? And if you don’t envision full repeal, what do you think is going to happen over the next ten years to federal taxation of testamentary and inter vivos transfers?

RF: I think the betting is that the estate tax will not be repealed. In the next few years Congress will do one of two things: Either they’ll stop the process in its tracks, when the rate is, say, 47% and the exemption is $1.5 million, or perhaps they will touch it up in some way. When we consider the budget surplus, which has disappeared, and the need for funds for military and other reasons, which has jumped up, and the sacrifices some people are making to be in the Army, I just think the climate has completely changed, and there’s no way they’re going to repeal the tax.

DR: But I think you have to add that the longer they wait to deal with this it’s going to be very hard to cut back on whatever exemption we’ve achieved. The reason they could sell repeal as being a low budget cost was because it was so back loaded. So the longer they wait to deal with it the more years that there’s going to be a tax cut in the ten year window that’s involved in the budgeting process. My prediction is that if Bush is not re-elected you’re going to see it go in 2005, at a $2 million exemption. I think they’ll try to sell it as, “Okay, we’re eliminating that windfall benefit for someone who happens to die in 2009 or 2010, but look, we’re still giving a nice cut after 2010.”

DE: I was very much in favor of estate tax repeal for a number of policy reasons: I don’t think it promotes economic equality the way people think it does, and I think that the tax tends to fall haphazardly. It tends to fall most heavily on people who die young or haven’t done estate planning. With enough estate planning and enough years to plan you can avoid it. So I was all in favor of repeal. The thing that changed my mind in favor of retaining some sort of transfer tax was the idea that it’s a backup to the income tax. Without a transfer tax it’s too easy to avoid income taxes by transferring income producing assets back and forth within the family. So that changed my mind and, if I were a betting man, I would put odds of only one in ten of us ever seeing estate tax repeal. I think what we’re going to wind up with is an exemption of $1 or $2 million and a flat tax at the top income tax rate, say 35%. At that level it is almost not worth evading the estate tax. Because anything you do to avoid the estate tax is too likely to result in capital gains or ordinary income. So it serves the function of backing up the income tax system, allowing us to go back to a step-up in basis at death and avoid the carryover basis nightmare. But it’s not a big impact tax and it’s not going to consume a lot of people’s time and energy planning for it. I’m reminded of the 50% top tax rate under the Economic Recovery Tax Act of 1981 because I think that’s a prime example of how promises often get changed as time goes on. As part of the [1981 Act] we were going to have a 50% top rate. At that point the top rate was 70%. It was going to go down in 5% increments and it was supposed to reach 50% in ’84. In ’83, Congress said, “No we’re going to postpone that to ’87,” and then in ’86 they said, “No make that ’93,” and then in ’93 they said, “Oh forget the whole thing. It’s fifty five percent and a five percent surcharge on larger estates”.

RF: And there was retroactivity in there. They did it in April and it was retroactive to January 1. That was a scandal.

DE: And that was in boom times economically. And now, as you point out, we may still have some lean years coming up. So Congress is going to be under pressure and I don’t think repeal is going to happen.

CS: My sense, my best guess is that we’ll see the phase-in of the changes through 2004, which will get you to a $1.5 million exemption and a 45% bracket, and we would then have it

continued on page 4
Drafting Under the 2001 Tax Act, continued

stop at that point and not see repeal for the reasons that have been stated: The economy and we cannot afford it.

RF: Even if Bush is re-elected?

CS: Even if Bush is re-elected. I just don’t think the dollars are there without touching the Social Security Trust Fund. If you look at recent votes in Congress, where there has been an attempt to get some consensus, that’s been the issue that people have been pushing, Social Security.

**Moderator:** What pressure, if any, do you see coming from the states?

CS: No state death tax credit?

RF: The states have been hurt.

CS: Florida, for example, clearly is going to have to do something.

RF: An ACTEC fellow did a study showing that if you run through the numbers for the first couple of years, a reduction in the federal estate tax falls 90% or even 100% on the states and not at all on the federal fisc. So the question is, if they do what we kind of think they might do and freeze things at the 2004 or 2005 level, what do they do about the state death tax credit? Are they going to convert it into a deduction? Are they going to eliminate it? And I think a lot of the state tax departments are talking to each other. It’s not a problem in Pennsylvania because we have an independent Inheritance Tax. But the states that have slack taxes or that have slack taxes that are keyed to the amount of slack tax that would have been in effect in the year X, which is New York and a couple of others, need to do something.

DE: I know one state, Rhode Island, actually changed its law to pick up the state death tax credit calculated according to the law prior to the 2001 Act. In other words, they froze it.

DR: New York and Virginia have written theirs in the same way.

RF: It occurs to me that someone like Bush might say, “Look, I can see having an estate tax and I can see having a federal estate tax. But I want to give the money to the states. We’ll have a full credit and that will assure uniformity among the states. The states will get the money because I’m a states’ rights kind of guy. And yet some people say we shouldn’t repeal the tax, so I’m not repealing the tax.” He could conceivably get some political benefit. And maybe not a 100% credit but a much bigger credit than it is now. He’d be raising less money, of course. But that would have a certain political appeal if I was in his position. I have told clients that they ought to think about moving to Florida because when the federal estate tax credit for state death taxes becomes a deduction it’s much less valuable and Pennsylvania has a free standing inheritance tax.

DE: For some years the total tax burden actually goes up because of the reduction in the [state death tax] credit, despite the reduction in the federal rates and credits. There are years from one year to the next in which total taxes for a Pennsylvania decedent will actually go up.

Moderator: Is there any lobbying going on now that anybody is aware of?

DR: It would only take one legislature to restore the money to all the states if you do it through restoring the state death tax credit. If each state has to act individually, it’s a nightmare. So there might be a very potent lobby for doing something on the state death tax credit.

RF: If they have any clout. It’s not entirely clear they have any clout in Congress.

DE: I’ve always thought the old state death tax credit was sort of an anachronism: The sliding scale and the progressive rates that continued to go up as a bigger and bigger percentage of the estate even after the federal estate tax had reached its maximum rate meant that the states were getting progressively larger and larger shares of the tax even though the tax remained the same.

RF: The states were getting 16% and the feds were getting 39%.

DE: I think there will be some political pressure to reinstate some sort of a state death tax credit. I’d like to see it as a percentage of the federal tax, like the states can get as a GST credit now. Whether it’s 20%, 30% or 50%, that’s a political decision. That makes sense to me. Of course, when has Congress ever done anything that makes sense?

Moderator: What about the proposed repeal keeps you awake at night?

RF: Nothing in the tax law keeps me awake.

DE: I will say this, one of my resolutions is that I don’t want to be the last lawyer paying federal estate tax. About two years ago, one of a wealthy couple died and I talked the surviving spouse into filing a disclaimer and paying some estate tax. And then the discussions of repeal started and I thought to myself afterwards, I’m never doing that again.

continued on page 5
Drafting Under the 2001 Tax Act, continued

With the new regime, paying some tax in advance no longer makes any difference because there is not going to be much of a difference between the top and lower brackets. In 2006 we basically have a flat tax of 45% once you get above the $2 million exemption. Even today, paying tax on the $2.5 million of the combined estate only saves you something like $30,000, and you have to pay $1 million in tax in order to save $30,000, assuming both die within a year or two. If they die once the 45% tax rate is in effect, you’ve lost money.

RF: So you’re saying you would not pay federal estate tax at the first death.

DE: That’s right. Even gift tax. I no longer want to pay gift tax. Even though I can still make a theoretical argument that the gift tax rate is effectively lower because of the tax inclusion versus the tax exclusion.

RF: Well that’s why GRATs to me are the ideal thing to do now. You do a GRAT under Walton and there’s no gift tax.

CS: Especially with the market down.

DE: But the Waltons got no benefit from the GRAT whatsoever.

RF: That’s because they put the wrong stock in the GRAT. That was the problem.

DE: Well it was Walmart stock. But your point about the GRAT is a good one. The GRAT is a strategy that still makes sense because there is no cost to it.

RF: Heads I win. Tails I come out even.

CS: It’s important to keep in mind that it’s our clients who are making the decisions. I’ve had a couple of situations in the past few months where you lay out the alternatives and certain clients have concluded, because of valuation issues or other factors, that it still makes sense to pay some gift tax because they’re pretty certain that a year from now that stock or that asset is going to be worth a lot more. So it’s always a matter of degree.

RF: But it also means that you’ve got to explain it because you don’t want the kids coming back later when the tax has been repealed asking, “Why did you advise my parents to give us this money in 2002 when, if they’d waited ten years, they could have given it to us for free instead of paying all that gift tax?”

Moderator: What about documents that have formula clauses, especially up front GST clauses? Do those keep you awake at night? Knowing that those are ticking out there.

CS: It depends on the dispositive provisions of the trusts that are being funded. If you have a marital and a nonmarital where the spouse is the primary beneficiary in both cases, it doesn’t matter. But certainly you’d have to look at the dispositive provisions.

RF: Well, the thing that I’ve recommended to a number of clients, and I increasingly like it for a variety of reasons, is a one-trust. I say to the client, “If there were no tax laws, what would you do?” And they’ll say, “Well, there are creditors out there and possible re-marriages out there so I’d leave everything in a trust for my spouse and then to the kids.” And I say, “Alright, let’s do that.” Then, at death you can do a partial QTIP election and a reverse QTIP election . . .

DR: And a division.

RF: And a division. And you can divide the trust into shares. But the will is then really simple. When clients read the typical A/B trust plan, the fact of the matter is no matter how many times I explain it, honest, if you asked them to answer a quiz on it, they wouldn’t understand. Maybe one out of ten would. And I’m pretty good at explaining it. Unless they’re really into inheritance taxes, they don’t get it.

DR: Do you tend, in your credit shelter trust, to allow bypassing the spouse on income?

CS: You could do a spray. But then you wouldn’t have a one-trust.

RF: The problem with the one-trust is that the spouse gets all the income from everywhere. Of course, then someone asks, “Can we get something to the kids?” Sure, the income can be automatically paid to the kids, or you could just give the kids the $600,000 or $1,000,000. Well they don’t want to give them the $1,000,000. They could have a sprinkle, so it’s available to the wife if she needs it, but it’s also available to the kids. But then you need an independent trustee. Well, for three out of four clients, that’s the end of that plan. They want the wife to be trustee of the wife’s money. I find that even though from a tax point of view there are a lot of advantages to an A/B plan, on balance, the average client most of the time is happy with a one-trust will. It’s simple to explain and we put the complicated tax work off until the person dies. And the other thing, apropos of what we’re talking about, maybe if I do an A/B plan, I’ve got the formula wrong, if...
Drafting Under the 2001 Tax Act, continued

the exemption goes up or something happens. Whereas if it’s completely discretionary with the executors at the time, then at that time, I’ll figure out what to do. So more and more I like the one trust plan. I like it for most clients because it’s the one they understand the best. And I like it because it postpones the decisions and the complicated tax work until some later date.

CS: When you have a second marriage, children from different marriages, it’s a lot more complicated and you’re not going to have that arrangement.

RF: Well that’s different.

DE: Sometimes you have the situation where they really don’t want a trust and then you have the disclaimer trust plan where everything looks simple and they can disclaim whatever they don’t want.

DR: And the other way is to put it in the trust and then have an independent person have the ability to collapse the trust if they determine it’s not needed.

RF: It’s the independent person that hangs people up. If you have somebody who says, “I’m very motivated by taxes and I’d like one of the banks to be trustee, tell me what you recommend,” then I can have a field day. But I don’t have too many clients that fall into that category.

DE: I very often explain to my clients that estate planning is a sort of continuum between low impact things and things that have a big impact on you personally and most cli

ents fall somewhere in between the extremes in terms of how much taxes they want to save and how much hassle they are willing to put themselves through, either during lifetime or when one has died.

RF: I’ve heard some lawyers, not Philadelphia lawyers, seriously say that they do stay awake at night because they are thinking of how they could draft clauses to say, “If I die in this year then the clause says this and if I die in that year the clause says that.” You could see some extremely compulsive personality figuring that they have to solve this great jigsaw puzzle, or this great acrostics puzzle, and they’re really working on it.

DR: I think there’s too much hype about this Act.

RF: I agree completely. They keep saying this is the biggest thing since sliced bread, and it isn’t. To me the real concern is, you do a great will, and the client becomes incompetent. Some years go by and the law is completely changed. And what do you do? Well, in Pennsylvania, in the Probate Code we have a provision that says if somebody is incompetent, the guardian can do estate planning for the incompetent. So with court approval you can change the will. And I think it specifically says for tax reasons. So I figure I’ll get a guardian and go to the judge and the judge will say fine.

CS: You also have durable general power of attorney provisions.

RF: That probably doesn’t authorize you to change the will.

CS: To the extent that you have a living trust, or a trust, and you have the ability within the trust document or in the power of attorney to be more specific, you may be able to give proper authority.

Moderator: Has anybody here ever used that power in the statute to change a will?

DE: I think I’ve read a reported decision.

RF: We’ve used it to make gifts.

DR: Yea, we’ve used it to make gifts.

RF: I’ve never actually used it to change a will.

CS: I’ve seen a living trust document written — and this was even before the tax law change — which authorized the back-up trustee in the event the settlor became disabled to make certain elections or changes. This was put into the document in order to take advantage of changes in credits.

Moderator: So that was an affirmative decision on the part of the trust maker.

CS: Which would address the situation where you know you have the early stages of Alzheimers, but you still have capacity and you want to remain flexible.

DR: I am troubled about relying too much on the power to go into court and get a guardian appointed. Because I’ve found that every time we’re dealing with a situation of someone who is arguably incompetent, the issue is just that. It is rare that the person is in a coma and completely incompetent. And the family is usually very reluctant to take the steps that they have to take to get the guardian appointed.

RF: Yea, but you have the added feature, you say to them, “You’ll save a million dollars in taxes.”

continued on page 7
Drafting Under the 2001 Tax Act, continued

CS: But you’re still talking outside of the context of having a fairly flexible will. To use your example from before, a one-trust will, if you have the right fiduciary and make the right elections you can get where you need to get. Something you could do today, if you have provisions in documents where you are tying the amount going to charity or going to a particular person to your adjusted gross estate or some similar figure, is put in language saying if the tax is repealed then use the amount it would have been had the tax not been repealed.

RF: In other words, I give 5% of my gross estate as determined for federal estate tax purposes to charity. And the problem is it’s not going to be determined for federal estate tax purposes because there is no federal estate tax.

CS: Correct.

DE: I think the courts will figure that out.

RF: Yea. I don’t see that as a major issue. But you could put the words in. I don’t think it would hurt.

DE: I’m not rushing out to redraft any of my documents. I think all the formulas continue to work with the increasing applicable exclusion amount etc. But I am wondering what happens if the document is not changed and the estate tax is repealed and I have this formula marital deduction which refers to the least amount necessary to reduce the estate tax to zero. Does that mean the surviving spouse gets nothing?

RF: The answer to that is literally yes, because you don’t have to put anything into the marital trust. On the other hand, if the nonmarital trust is for the benefit of the spouse, what’s the difference? But I tell you there is this case in Pennsylvania where our law firm made a booby. We gave that amount to the wife, just as you described. The smallest amount to reduce the federal estate tax to zero. This was in the days of the 50% marital. And the residue to charity. I forget the name of the case offhand, but it was reported in the Fiduciary Reporter. And the court saved the day by saying it was 50% to the wife. That’s obviously what the testator intended. There was no intention to disinherit her. So I think if the same thing happened, if they repealed the federal estate tax — which none of us think they will do — they might have a clause in the repeal that would say, “Absent a state law to the contrary, something that refers to the marital deduction in some way will be deemed to mean so and so.”

DR: But the federal estate tax is only repealed for a year. So if they don’t do anything, they’re not going to do something just to save the planning for a year. The only way they’re going to do that is if they permanently repeal.

RF: Just for one year, they wouldn’t bother, you’re right.

DR: The one place it occurs to me that you don’t want to wait until 2010 — I don’t know when you want to start thinking about it — is in the case of a formula, where you only give the spouse this minimum amount or minimum fraction. So potentially in 2010, everything is going into the credit shelter trust. Suppose the credit shelter trust is a sprinkle trust. Then suddenly instead of getting a potential step-up in basis of $4.3 million, you’re only going to get a potential step-up in basis of $1.3 million. That’s one area that I think you have to think about.

RF: Could you cover that by disclaimers at the time? Could the nonspouse sprinklees disclaim?

DR: If it’s for issue? What about somebody who’s born tomorrow?

RF: They could disclaim within nine months of turning 21.

DR: Yea, but you need to qualify as of date of death.

RF: Yea that could be a problem.

Moderator: In a second marriage situation, if you’ve got a formula that sets up a trust for the children of the first marriage, as the exemption goes up, it starts to eat up a larger part of the estate. How big a problem is that?

CS: In my experience, it’s only going to be the husband in the second marriage who would consider not making provisions for children of the first marriage. Ninety-nine percent of the cases, in second marriages, the mother is going to provide for her kids, regardless what the taxes are.

RF: Dads are just less connected.

CS: That’s been my experience. And so I think in those situations, people are going to be looking at the taxes and then have to decide how motivated they are to provide for their kids and bite the bullet.

RF: Maybe the answer to that is to do what we have sometimes done in other contexts. You could easily say in your drafting, I give an amount equal to the federal estate tax exemption to a trust for my children by the first marriage, provided, that amount shall not exceed 30% of my estate or some cap like that.

continued on page 8
Drafting Under the 2001 Tax Act, continued

CS: I did that for a grandmother who was setting aside money on the GST side. The document was originally drafted before the law changed. It said I give the full amount of the GST exemption. Then we revisited where to cap it.

DE: I've done that a lot of times with GST gifts, limiting it to not more than a percentage of the estate.

Moderator: And it seems like an easy fix. Would you now recommend going back and looking at — and this, of course, is a nightmare for most people to think about — all those wills out there that have formula provisions in them and don't have a cap? Would you recommend writing to clients . . .?

RF: No, no.

CS: For larger estate plans, you tend to be in touch with those clients more often. And you're revisiting issues and have opportunities.

RF: That's right.

CS: For smaller estates it's going to be less of an issue.

Moderator: But is it? For smaller estates if we get up to a $4 million exemption that could be the whole estate.

DR: But what's your plan for the smaller estate? Your plan for the smaller estate isn't really going to be inhibited that much by the changes in the law.

CS: Because normally in the smaller estate you were providing for the surviving spouse. You didn't have these big GST provisions. You weren't inclined to do the spray for just the children.

DE: Unless it was a second marriage situation.

RF: The real problem is, suppose the couple comes to see you and everything is hunky dory between them and he has kids and she has kids and they have no common kids. Standard. They don't have a hundred million dollars. They have three million dollars. And really what they want to do is leave everything to each other because they've been married for twenty years and they love each other and the survivor is going to need the money. And a lot of them have the attitude, if the kids get something in the end, that's all very nice, but first we've got to take care of each other. So they have a will or joint ownership and everything goes to the survivor. Forget about the taxes. Now the survivor gets older and Suzie Q or Handsome Harry moves in with the survivor to take care of him or her. And they live in Florida and the kids are up here and the kids don't see them all that much. They can't take care of themselves quite as well. Everybody knows this scenario. What happens is they just naturally make a new will and instead of giving everything 50% to their kids and 50% to the dead spouse's kids, which is what the old will said, the new will says everything to Handsome Harry or Gorgeous Suzy. Or one of their kids comes to take care of them and they give everything to their own kids who have been so good to me and the step-kids are disinherited.

CS: But you have that all the time.

RF: The problem is the law does not have a real easy way of handling that. What you really should have is a blockbuster will that covers non-probate property that gives everything in a marital trust and then the marital trust goes 50-50 at the death of the survivor. Now that doesn't cover the survivor's own separate property, but it covers the decedent's. And then you put a separate clause in with a hotchpot so that if the survivor gives his or her own property to his or her own kids, that's credited as an advancement of what those kids get from the first spouse's trust. That is the big need in the law and it's not mainly a tax issue for second marriages. If we get closer to repeal and bigger exemptions, I think we're going to see more transfers between spouses. And you may see situations in second marriages where there is some negotiation about putting assets into an inter vivos marital trust in an attempt to take advantage of the survivor's GST exemption or to take advantage of available credits and exemptions.

Moderator: Are you preparing more intervivos QTIPs now?

CS: Not yet. But people are thinking about it.

DE: I've run into a situation where I started to recommend one of those peculiar revocable trusts which gives a general power of appointment to the first to die.

RF: Well, the settlor always has that. So it's just giving a general power to your spouse if your spouse dies before you?

DE: That's right. In order to create a taxable estate in the poorer spouse, if that spouse should die first. In this case it is the woman who has the assets, which are inherited. She has $4 million. He has basically nothing. She puts assets into a trust in which upon his death he has a general testamentary power, which causes those assets to be included in his estate, and the document talks about what hap-
Drafting Under the 2001 Tax Act, continued

pens if he doesn’t exercise that power. So there can be a unified credit trust created out of her assets for her benefit. And the IRS apparently blessed this in that Private Letter Ruling.

DR: Although that was a joint trust.

DE: That was a joint trust. But sauce for the goose, sauce for the gander. Shouldn’t it also work for a one settlor plan?

RF: If she dies first, he’ll have an estate at his later death, because she’ll give him some dough in a marital trust. And if he dies first, he’ll use up his exemption, so at least $1 million of her revocable trust becomes irrevocable. That’s an interesting idea.

DE: I started off trying to recommend the irrevocable lifetime QTIP. But she didn’t like that, because of the word “irrevocable.”

DR: But there is a price to it. And that is no step-up in basis.

DE: Well, I don’t think the Private Letter Ruling is clear on that. I think you do get a basis step up.

DR: The rule in §1014(e) says you don’t get a step-up in basis if the property’s been transferred to you and you give it back. The only question is whether the form of the give-back triggers §1014(e).

DE: What if the give-back is in the form of a trust and the surviving spouse is only one of several beneficiaries? Suppose it’s a sprinkle trust?

CS: You’re also balancing, based on the magnitude, whether you need any of this for the marital or is it going to be fully covered by the exemption.

DE: Oh there’s going to be a formula that gives stuff back to her and that won’t get a step-up in basis. But that’s okay. I’m no worse off there than if I hadn’t set up the trust.

RF: That’s an interesting idea.

DE: The loss of basis is something that’s bothered me for a while. The ruling itself was ambiguous.

RF: Didn’t the ruling say, “We’re not ruling?”

DR: Did they say they weren’t ruling or that there was no step-up in basis?

DE: They said there was no step-up in basis, but they were only . . .

RF: Isn’t that the case where they were trying to get the double step-up in basis?

DE: Yes. They were asking for a double step-up. And the ruling says, “No you don’t get a step-up for the assets that go back to the original owner.” Well, that doesn’t answer the question, what about the stuff that’s still in the trust that’s now irrevocable and, according to the IRS, was included in the decedent’s estate? It’s not going back to the original owner. It’s just in a trust of which the original owner is a beneficiary. What happens there? I went through the legislative history and there’s no clear guidance. It denies the step-up for assets going back to the original owner directly or indirectly. But to me indirectly means you make a gift to a partnership of which the original owner is the general partner or to a corporation, that sort of thing. That doesn’t necessarily apply to a trust relationship. But I think this joint revocable trust may have some more application because it helps us deal with things like an increasing exemption. You know a typical estate for me is they have $2 million in assets and $3 million in an IRA. It’s awfully difficult to deal with the IRA in those circumstances. What you really want is to make sure you get the advantage of the unified credit for the $2 million and so the joint revocable trust may work very nicely.

Moderator: So everyone is reasonably comfortable about not making dramatic changes. Is there anything you think does need to be addressed, information that needs to be passed onto clients? Are there certain circumstances where you think people need to do codicils? Or need to revisit their plans?

RF: If you already have a will that you did for a client, do you contact the client and say, “The will we did for you has a clause that mathematically is dependent on what the federal estate tax is. Now the exemption is bigger, the rates are lower and it could be that the tax is repealed. Nobody knows. And if you would like us to review how this formula would actually work in your case, and perhaps tinker with it, let us know.” We could write such a letter. I have not done so.

CS: We have a computer system where you log in key attributes when you put documents into the vault. And so we have a printout that identifies certain attributes. We have run the reports, but we have not gone to the clients yet to tell them. We are waiting to see what happens.

continued on page 10
Drafting Under the 2001 Tax Act, continued

DE: I sent out a newsletter sort of thing early on that just said, "Here's the tax law. Don't worry about it. Whatever you've got now is going to be good for at least several years. We'll get around to thinking about it in the future. Don't panic."

RF: The only case in which we've written to clients, in a general newsletter, is if it's a second marriage and the exemption amount goes to somebody different from the marital trust. Then we say, this could distort your plan because when we did your plan it was $600,000 and now it could be $1.5 million or $3.5 million and if this is a problem, call us. Nobody called us.

CS: We're dealing now with some of the other issues that have come up, like the deemed allocation for GST.

Moderator: Has everybody written letters on that?

RF: We're working on them.

CS: I'm in favor of circulating newsletters, but I'm not necessarily in favor of writing a letter to every client and saying, "Call us and tell us if you have a trust."

RF: Well, analytically, the first issue is, if there's a will out there, what if anything do you tell a client because it has a formula clause that's dependent on the federal estate tax which is undergoing rapid change. The second issue I think is what if you have a client for whom you haven't done any will at all, a new client, what would you do in light of the new tax law? Would you change your existing standard forms of docu-
ments? And I haven't heard anyone around the table saying they're doing that — other than the suggestion I had of the one trust document.

DR: Or the power in some independent person . . . .

RF: The trust protector.

Moderator: Or, as Cliff pointed out, a cap on the formula clause.

RF: Yea. So that would be in the case of the will you haven't written. If somebody comes in green and wants something brand new, how would you do it? You could have a cap, you could have a trust protector, you could have a one-trust form, a disclaimer.

DE: Suppose somebody comes in, and they have $4 million and they're not married and they're facing an estate tax liability if they die in the next few years but not if they live long enough. There are a lot of things we've been doing over the years to reduce estate taxes. I'm not sure that the longer term techniques, the QPRT for instance, still make a lot of sense.

RF: Well, the problem with the QPRT is you have to pay gift tax. We're thinking, maybe you shouldn't pay gift tax. So why do that? Suppose somebody has $4 million and his wife has died and he has a couple of kids. It seems to me you tell him one of two things: Either keep your money because your new wife when you get remarried is going to want it, or dish out $11,000 to each kid per year and when you get older, we'll worry later.

DR: And keep in good health because the exemption is going to be higher.

DE: If somebody really doesn't want to lose a million dollars to taxes if they die within the next four years, is life insurance an alternative?

CS: Partly depends on the age of the kids. What are the needs? You might be able to replace the tax with a term insurance policy.

RF: I had one client who decided to do that. He said, I want no federal estate tax. The insurance agent said what you want is basically a decreasing term policy for the next nine years, so you could cover the federal estate tax. And they sold it. The agents are very persuasive and they can sell this kind of stuff. And the guy felt good. It's like the pet rock. Remember the pet rock?

DR: I have a real problem with that. Decreasing term insurance will solve the problem only if full repeal is made permanent after 2010. Any other change to current law — or no further change — will mean that the insurance will not be in the right amount — unless the client is "lucky" enough to die in 2010.

CS: I think a lot of the same tools are out there. It's a little more complicated because we're dealing with a moving target. Nobody knows precisely when they're going to die and what the law is going to be at that time. A lot of the planning is still the same.

DE: For instance, a family limited partnership still has viability because it works and it has immediate impact. You've immediately got your 30% or 40% discount the following day.

RF: We didn't tie up the client who's beginning to go into the twilight zone. They have some money, so taxes are important. And they have an estate plan. Is there anything you do now, knowing that in a year or two you may not be able to do anything because they will be incompetent? I think the answer is you do one of two things: You either have a general continued on page 11
Drafting Under the 2001 Tax Act, continued

power of attorney that has some special language in it that you hope will allow the agent to revise the estate plan either in general or in particular. Or it seems to me you have an estate plan with a protector in it and the protector is some third person who can essentially rewrite the estate plan. I’ve seen Europeans tend to that sort of thing. I haven’t seen too many Americans who like it. Or the third possibility is you do nothing but perhaps you have some letter signed by the client that outlines their general estate plan, what they’re looking for independent of taxes. Then, if and when they are incompetent, you get a guardian appointed and, because of this letter, the guardian knows what the client wanted before the tax law changed. The guardian then goes to the Orphans’ Court and says, “Let’s revise the plan to accomplish what the client wants. The only reason the client said what they did was because of taxes. Taxes have changed so now we need a different plan.” And my guess is that the Orphans’ Court would approve that routinely — unless there’s a dispute.

CS: In the normal traditional family situation.

DR: It’s hard for me to think of the situation where I can’t do a fairly good job of getting a plan set up that’s flexible. Because to the extent it’s a tax issue, I’m not convinced there’s a lot to change. So the real issue is dividing between spouse and children of the first marriage and I think you can do that by just putting caps on what the kids get.

Moderator: Suppose we get full repeal, and the estate tax is replaced by changes in basis allocation, does that concern anybody?

RF: There’s something that we don’t now know that you would need to do.

DR: Carry-over basis may be the one thing we would have to think about.

CS: But it’s way too early.

RF: Or something else we’re not anticipating. Ten years ago, would you have anticipated that they’d repeal the federal estate tax?

DR: Two years ago I wouldn’t have anticipated repeal.

RF: So it seems to me there are answers to all these things and the one thing that is not necessary is to over-plan. That would be my conclusion. It’s like the client who came in to see me who was an engineer who was used to flow charts. He said he wanted a decision tree for everything that could happen in his children’s lives from now on, and asked if I could write the trust to handle all those contingencies. That’s over-planning.

DE: You know when you read the advice columnists they’re always talking about the dangers of not getting enough estate planning. I see more estates that are over-planned than under-planned. My job usually winds up being trying to simplify things.

RF: That’s because of who you see. If you saw the average American — their estates are under-planned because they’re not coordinated. In other words, the insurance goes here, the joint bank account goes there. But most of us in our practice don’t see those clients. The clients we see are over-planned. I agree with that. And it’s the less skilled estate planners who over-plan because they think that’s what they have to do.

Moderator: Do you think we’ll see more litigation down the road because of this?

RF: Litigation is dependent on people’s attitudes. And if somebody is angry.

DE: They’ll just find a different excuse to litigate.

RF: That’s right. They’ll find a reason to fight. People can fight over nothing. They can fight over who gets the art book on the coffee table. It’s not dependent on what we do. It’s dependent on the mood of people.

Moderator: This gets back to people’s expectations with respect to the way they set up their plans and whether the plan is working.

CS: There’s also the privity issue. We’re getting to a stage now where it’s coming to a head whether beneficiaries will get stronger standing to bring a case.

RF: You mean against a lawyer? For not doing the will right?

CS: Correct. You mentioned before, kids coming in after mom and dad are both gone. Up until this point, they’ve had limited, if any, standing. But there’s been some movement.

DE: That’s a sobering thought.

Moderator: What about gifting programs?

RF: Well, clients are hesitant to pay gift tax now because they think the gift tax may be less, although the proposal is not to repeal the gift tax.

CS: They do have a little bit more of a bump right now, so we are talking
Drafting Under the 2001 Tax Act, continued

to clients when they come in, or if it’s appropriate when we’re preparing gift tax returns, just to remind them that there is that little bit of extra cushion. But they have to be careful. If they’ve paid gift tax before, they do not have a full $325,000 of additional exemption because of the bracket shift. But they can make some more gifts this year.

DE: And as far as we know, that’s the end of it, because the unified credit is now a disunified credit.

RF: If you can make a gift without paying any gift tax, that would be great. So make $11,000 gifts to everybody you can think of. And have a GRAT because you can zero it out.

CS: With low AFRs.

RF: GRATs are particularly attractive with low interest rates. On the other hand, the stock has to appreciate. Maybe you could do a partnership arrangement that doesn’t involve gift tax. Or maybe a QPRT.

CS: But there, it cuts the opposite way. If interest rates are low, the QPRT is not as desirable.

DR: What about total return trusts?

RF: I don’t think you have to draft any differently than you do now. When we wrote the law, our concern was, if you went to the legislature and said people should be able to write unitrusts if they want to, they would ask, well are people doing it now? Is there a need for it? Actually, there were relatively few cases where people were writing unitrusts. So the statute is great because it writes a unitrust for you. You write the old garden variety thing, paying all income to A for life and then the trustee, with all the beneficiaries’ approval, can convert to a unitrust.

DR: What about federal tax issues?

RF: I think they’re all taken care of under the proposed regulations. In other words, we have an ordering rule in our statute and in the federal tax announcement, they said, “If your state has an ordering rule, you’re okay.” And the ordering rule means, the first dollars come out of regular dividends and interest and the next dollars are short term gains and the next are long term and then principal. And in the announcement they said they’d respect that for federal tax purposes. And we think that’s pretty good.

CS: We usually draft with the ability not only to distribute income but discretionary distributions of principal, as well. In effect you could convert it anyway.

DR: We use one where we distribute 5% a year and any excess will be out of the discretionary power to distribute principal.

RF: Of course the problem will arise if interest rates go up and you have some bonds that are paying 12%. The advantage of the unitrust would be that you could accumulate some income. But at the moment that’s academic.

Moderator: Final question. Do you think people will give less to charity?

RF: I have not seen a lot of clients who say, “Well the tax savings from giving to charities is less, so I’m going to give less.” What I have seen is people who say, “My next door neighbor, or my friend or the guy I regard as my peer is doing X, and I want to keep up with him. And if he’s getting the building at the medical center named after him then I need the building at the other medical center named after me. And the taxes are whatever they are.” For other people who give, who don’t have mega bucks, the tax benefits are just icing on the cake.

CS: I’m seeing it on a generational level. The older generation is continuing to give. The mid-level, younger generation people are a little more reluctant. They’re more tax driven. The older generation, especially if they’ve been in a pattern of giving before, are going to continue to give.

DR: It’s rare that you see the tax savings is anything more than the icing. It might marginally change the amount, but it’s not what drives the charitable gift.

RF: I’ve never had a client say to me, I can afford to give $1 million to charity, you tell me how much to write the check for so that out of my pocket, net, it costs me $1,000,000. I’ve never had a client say that.

DR: I’ve never had a client ask me.

CS: It may be a different question, if we’re in 2010 or there’s repeal and then there’s no tax.

Moderator: Any other thoughts?

CS: As the exemption goes up and if we get closer to repeal, we will be having many more of these conversations.
Impact of 2001 Tax Act on Necessity to File 2001 Gift Tax Returns

By CHRISTINA MESIRES FOURNARIS
MORGAN LEWIS & BOCKIUS LLP

The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (the “2001 Tax Act”) made significant changes to the transfer tax system. Certain of the provisions in connection with the generation-skipping transfer tax (“GST”) have an immediate impact on 2001 federal gift tax returns that are due April 15, 2002 (unless extended). As a result of the new law, it is important that advisors, tax return preparers and clients consider all trusts to which transfers were made after December 31, 2000, and whether it is necessary to file a gift tax return for calendar year 2001 (even if it was not necessary to file a gift tax return prior to calendar year 2001).

The 2001 Tax Act added section 2632(c) to the Code, which provides that if an individual makes an indirect skip gift during his or her lifetime to a generation skipping trust (a “GST trust”), any unused portion of the individual’s GST exemption automatically will be allocated to the transfer. The Code defines a “GST trust” as a trust that could make a generation skipping transfer with respect to the transferor unless the trust meets one of six exceptions. The six exceptions generally reflect the idea that despite the broad definition of a GST trust, there are certain kinds of trusts with respect to which most individuals would not choose to “waste” their GST exemptions.

It may not be desirable from a tax planning standpoint to allocate GST exemption to trusts for a number of reasons. For example, clients may wish to save the use of GST exemption for other purposes such as a gift in connection with a gift/sale to a defective grantor trust or for future transfers to trusts for grandchildren. Also, if a trust holds a term life insurance policy, it may be preferable not to allocate GST exemption to insurance premium payments because the term insurance is not a permanent asset.

If a client created a trust to which transfers were made after December 31, 2000, he or she may elect (i) to have the automatic allocation rules not apply to any or all transfers made to a particular trust (“opt-out election”), or (ii) to treat any trust as a GST trust with respect to any or all transfers made to it so that the automatic allocation rules do apply (“opt-in election”). These elections must be made on a timely filed gift tax return for calendar year 2001. Because the 2001 Tax Act does not explicitly state whether a taxpayer may change the opt-out or opt-in election for future transfers to a particular trust, it may be wise to opt out only for transfers in 2001 until this is clarified.

NEWSLETTER ARTICLES

What would you like to see in future issues of the Probate & Trust Law Section Newsletter? The Publications Committee is looking for articles and ideas of interest to the probate bar. Please send any articles or ideas to:

Susan G. Collings, Esquire
Drinker Biddle & Reath LLP
One Logan Square
18th & Cherry Streets
Philadelphia, PA 19103-6996
(215) 988-2618
Superior Court Provides Guidance on What Constitutes a “Confidential Relationship”

By JAMES F. MANNION
MANNION PRIOR, LLP

In challenges to Wills based on undue influence, proof that the proponent occupied a “confidential relationship” with the testator, that the testator had a “weakened intellect” and that the proponent receives a “substantial benefit” shifts the burden of proof to the proponent to prove the absence of undue influence. Estate of Clark, 461 Pa. 52, 334 A.2d 628 (1975). Proof of a confidential relationship alone is sufficient to shift the burden of proof in challenges to inter vivos gifts. Estate of Clark (No. 2), 467 Pa. 628, 359 A.2d 777 (1976).

A confidential relationship exists “when the circumstances make it certain the parties [did] not deal on equal terms, but, on the one side there is an overmastering influence, or, on the other, weakness, dependence or trust, justifiably reposed.” Leedom v. Palmer, 274 Pa. 22, 25, 117 A. 410, 411 (1922). The relationship of the parties is determinative:

Although no precise formula has been devised to ascertain the existence of a confidential relationship, it has been said that such a relationship is not confined to a particular association of parties, but exists whenever one occupies toward another such a position of advisor or counselor as reasonably to inspire confidence that he will act in good faith for the other’s interest.


Lurking in a May 2001 opinion of the Superior Court, in a case not involving a challenge to a Will or inter vivos gift, is the most recent appellate guidance on what constitutes a confidential relationship. Basile v. H & R Block, Inc., 777 A.2d 95 (Pa. Super. 2001). In addition to addressing the conflict among appellate cases regarding whether one needs to prove both overmastering influence and “weakness, dependence or trust, justifiably reposed,” the Basile court expressly confirmed that the test for a confidential relationship is a subjective analysis of the relationship between the parties on a “sliding scale”:

Our Supreme Court has acknowledged that “the concept of a confidential relationship cannot be reduced to a catalogue of specific circumstances, invariably falling to the left or right of a definitional line.” In re Estate of Scott, 455 Pa. 429, 316 A.2d 883, 885 (1974).

The Court has recognized, nonetheless, that “the essence of such a relationship is trust and reliance on one side, and a corresponding opportunity to abuse that trust for personal gain on the other.” Id. Accordingly, “[a confidential relationship] appears when the circumstances make it certain the parties do not deal on equal terms, but, on the one side there is an overmastering influence, or, on the other, weakness, dependence or trust, justifiably reposed.” Frowen v. Blank, 493 Pa. 137, 425 A.2d 412, 416-17 (1981) (emphasis added). The Supreme Court’s use in Frowen of the disjunctive “or” to separate the cognizable characteristics of confidential relationship is critical. Contrary to the trial court’s determination in this case, our law does not require both “overmastering influence and ... weakness, dependence or trust.” . . . Indeed, both elements need

---

1 See generally The Presumption of Undue Influence and the Shifting Burden of Proof, 18 Fiduc. Rep. 2d 348.


continued on page 15
ETHICS COLUMN

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

Question: Are we estate planning lawyers on the same slippery ethical slope as accountants?

Confidential Relationships, continued

not appear together as “in both an unfair advantage is possible.” Frowen, 425 A.2d at 417.

* * *

Both our Supreme Court and other courts have recognized that those who purport to give advice in business may engender confidential relations if others, by virtue of their own weakness or inability, the advisor’s pretense of expertise, or a combination of both, invest such a level of trust that they seek no other counsel. . . .

Although the language used to define such advisor/advisee relationships has varied over time and in response to the circumstances established by the record, the Pennsylvania Supreme Court has focused, consistently, on the disparity in position between the parties to determine whether their relationship is, in fact, confidential. . . .

Moreover, the Court’s decisions suggest that disparity between the respective parties is to be adjudged subjectively, and may occur anywhere on a sliding scale of circumstances.

* * *

We conclude that these cases, when considered together and in conjunction with prior authority, compel recognition of confidential relations between parties in a wide array of individual circumstances. The possibility of a confidential relationship cannot be excluded by a concrete rule. So long as the requisite disparity is established between the parties’ positions in the relationship, and the inferior party places primary trust in the other’s counsel, a confidential relationship may be established.

777 A.2d at 101-103.

“Confidential relationship” is not a concept limited to Will contests and challenges to inter vivos gifts. As the Basile case indicates, the civil division of the court often faces a claim of a confidential relationship in civil causes of action. As such, practitioners must be careful not to limit their research only to the traditional Orphans’ Court cases.

Prior to the ‘70s, the accounting industry was regarded with a high degree of trust and even had an image of serving as moral guardians. In the 1920s, they banned members from advertising and forbade accountants from stealing the clients of other accountants. It was a gentlemen’s profession in which accountants did not sell but engaged in the usual networking at country clubs, charities and service organizations. The top partner in the major accounting firms made no more than four times that of the lowest paid. In the 1970s, the Federal Trade Commission warned accountants about alleged anti-competitive prices and forced them to allow advertising. By 1990, most restrictions were gone and changes in the accountants’ culture were becoming apparent. Sound familiar?

The traditional very close relationship between the accounting firm and the client, primarily through audit and tax work, gave Andersen, and other accountants, the opportunity to convince the client they needed other products and services. Arthur Andersen’s consulting work through its subsidiary became so successful, and wrangling over the sharing of revenues so rancorous, that Andersen was ultimately forced to

continued on page 16
Ethics Column, continued

spin off the subsidiary which was re-
named Accenture. After the spin-off, 
Andersen, itself, continued to do con-
sulting work.

According to an article in 
The Wall Street Journal on March 12, 
2002, Arthur Andersen and the other 
Big Five Accounting Firms collect-
ively doubled their revenue in less 
than a decade, with most of the in-
crease derived from consulting ser-
dices with the revenue primarily ben-
efiting consultants and “hard-sell ac-
countants”, and not those accountants 
who engaged in traditional auditing 
and tax work. The Wall Street Jour-
nal reports that consulting accounted 
for about 22% of the revenue of the 
big firms in 1989, while it accounts 
for 40% now. In 2000, Arthur 
Andersen received $25 million in 
audit fees and $27 million in non-au-
dit fees.

The Wall Street Journal also 
reported that, while only three pub-
licly-held companies had to restate 
earnings in 1981, roughly 50 compa-
nies had to restate earnings in the mid-
90s and about 160 companies had to 
restate their earnings last year. In one 
high profile case, securities regulators 
alleged that Andersen was so anxious 
to sell the consulting work that they 
would go soft on the accounting rules 
and, in a case involving Waste Man-
agement, Inc., it was alleged the firm 
committed fraud.

A former Ernst & Young part-
ner, interviewed by The Wall Street 
Journal, claims he had to teach ac-
counting work on the job because the 
firm’s new hires were sent through 
more marketing training than auditing 
courses. He also said his firm set sales 
goals for partners and put them through 
sales training in 1995, requiring him 
to spend one-third of his time on “prac-
tice development.”

It is no secret that the legal 
profession has been eyeing the “su-
cess” of the accounting profession and 
has felt growing pressure to permit 
multi-disciplinary practices. Early last 
year, our own Bar Association opined 
that it is not contrary to the Rules of 
Professional Conduct for us to accept 
referral fees from non-lawyers, like 
banks, money managers and even life 
insurance salesmen, so long as there 
is full disclosure and the acceptance 
of those fees does not affect the judg-
ment of the lawyer.

Money certainly affects hu-
man behavior, and it is difficult to be-
lieve these changes will not diminish 
the lawyer’s independence and feel-
ing of loyalty toward the client. If we 
estate planning lawyers see opportu-
nities to sell other products and finan-
cial services to our estate planning cli-
ents, there could be a temptation to 
encourage the client to have a more 
complex and luxurious estate plan 
than really required, and to augment 
it with bells and whistles that are un-
necessary, unnecessarily expensive, 
not the best or all three. How can a 
lawyer act in the best interest of the 
client when he or she participates in 
fees derived from the sale of those 
products and services?

While we lawyers do not 
have the obligation to the public at 
large that accountants do in connec-
tion with their auditing work, our ob-
ligations to our clients are little dif-
f.

WHAT WOULD YOU LIKE TO SEE IN FUTURE 
ETHICS COLUMNS?

Send your questions and ideas to:

Paul C. Heintz, Esquire

Obermayer, Rebmann, Maxwell & Hippel, 
LLP

1617 JFK Boulevard
One Penn Center
19th Floor
Philadelphia, PA
19103
Tax Update

By ROBERT WEINBERG
PEPPER HAMILTON LLP

CASES

Revocable Spousal Interest in GRAT

In Cook v. Commissioner, 88 AFTR2d ¶2001-6485 (7th Cir. 2001), a husband and wife created separate reciprocal GRATs, each of which contained a provision continuing the annuity payment for the spouse for the remaining period of the specified term if the grantor died during the term. The spousal annuity interest was also contingent on the grantor and the spouse remaining married. The instruments permitted the grantor the power to revoke the spousal annuity interest. In valuing the taxable gift, the taxpayers subtracted from the total principal the value of a two-life annuity as a retained interest.

The IRS argued before the Tax Court that the revocable spousal annuity interest was not a “qualified interest” under IRC section 2702. The Tax Court agreed, citing IRC Reg. section 25.2702-3(e), Ex. 6, noting that the spousal interests were contingent and their values were not ascertainable as of the date of the creation of the GRAT. The taxpayers argued that an example in the regulations did not carry the authority of the actual text in the body of the regulations. The Court of Appeals for the Seventh Circuit disagreed that an example carries less weight than the text of the regulation.

The taxpayer also argued that the contingent interest was akin to the retained interest in Walton v. Commissioner, 115 T.C. 589 (2000), in which the GRAT provided that the annuity payments were payable to the grantor’s estate in the event of the grantor’s death. The Court of Appeals recognized the value of the continuing annuity in Walton as part of a single interest for a term of years under the reasoning that a grantor cannot make a gift to himself or to his estate. In the Cook GRATs, however, the revocable spousal annuity was contingent on the death of the grantor during the term and on the couple remaining married. Hence, it was possible that the spousal interest would never vest. The court also noted that the value of a gift should not be reduced by an ephemeral interest. Finally, the court concluded that the regulations required that a retained interest must be for life or a specified term of years, or for the shorter. In this case, the grantor’s right to revoke meant the spousal interest can exist for the life of the grantor or for a term of years, regardless of which term is shorter.

Unitrust Interest in CRUT Is Property of Bankruptcy Estate

In Lindquist v. Mack, 269 B.R. 392 (D. Minn. 2001), the debtor in a bankruptcy estate had transferred $1.65 million of corporate stock to a charitable remainder unitrust retaining for himself a 7% unitrust interest. He was the trustee. His wife and children were successor beneficiaries and trustees, although he retained the right to remove and replace them as successor trustees as well as the right to revoke their beneficial interests. He also retained the right to change the charitable remainderman. The settlor was solvent at the time of the trust’s creation. The CRUT sold the stock and made a number of high tech investments that caused the value of the trust to fall to $1.1 million in the next four years. Apparently, the settlor’s own financial fortunes did not fare well either, and he filed a bankruptcy petition.

The bankruptcy trustee claimed that the debtor’s unitrust interest was an asset of the bankruptcy estate, as was his right to remove and replace the trustees and to amend the trust to preserve its tax status. The debtor argued that his unitrust interest was protected by the spendthrift clause in the trust instrument. The court concluded that a spendthrift clause is ineffective where a trust is self-settled. The court further concluded that nothing in the Internal Revenue Code prohibited the assignment of a unitrust interest in a CRUT. Interestingly, the court ruled that the debtor’s right to revoke the successive interests of his wife and children and his right to change the charitable remainderman were not property of the bankruptcy estate because they were not exercisable for the benefit of the debtor.

Net Gift Does Not Apply to Donee’s Assumption of Risk of Undervaluation

In Estate of Frank Armstrong v. United States, 89 AFTR 2d ¶2002-513 (4th Cir. 2002), the decedent made a series of gifts of stock in a private company to a trust and paid gift tax on a value of $100 per share. He died within three years of the gift. Under an agreement with the donees, if the IRS increased the valuation on audit, the donees would be continued on page 18.
Tax Update, continued
liable for the additional tax. In fact, the IRS did increase the value to $109 per share. The trust and estate paid the additional tax and sought a refund, claiming that the value of the stock should have been depressed by the liability for additional taxes and the potential for the gross-up in the gift tax under section 2035(b)'s three year rule. They also contended that the children’s obligation to pay additional gift and estate taxes created liens or transferee liability at law. According to the circuit court, “[t]he taxpayers even alleged, remarkably, that Armstrong had retained the power to revoke the transfers ‘by refusing to accept heroic measures and procedures for prolonging his life or by otherwise acting, or refusing to act, in a manner calculated to eliminate his chances of surviving for three years’ after the stock transfers.”

The district court agreed with the IRS and the Fourth Circuit has affirmed. In the typical arrangement in which net gift principles apply, the donor transfers property to the donee on the condition that the donee pay all resulting gift taxes. In such a situation, there is no dispute that the donee is liable for the gift tax, even if the total amount of the tax is not determined until a later juncture. Here, the children only had an obligation to pay additional gift taxes in the event of an undervaluation of the transferred property, an event all parties sought to avoid by careful valuation of the stock and adequate funding of the trust. Because the donees’ obligation to pay additional gift taxes was premised solely on an undervaluation, a probability no one expected to arise, the obligation was contingent and too speculative to justify application of net gift principles.

Case Holds that Revocable Trust is Totten Trust

In Spinelli Estate, 21 Fiduc. Rep. 2d 298 (O.C. York 2001), the decedent’s will made a specific devise of real estate, but the residue was insufficient to pay the Pennsylvania inheritance tax on the devise. The tax was paid from the decedent’s inter vives revocable trust, which had the same beneficiaries as the residue under the will. The trust’s beneficiaries objected, claiming that the tax should have been paid by the devisee of the real estate. Noting that 72 Pa. C.S.A. section 9144(f) would impose the inheritance tax liability for the real estate on the transferees, the court nevertheless analyzed whether the revocable trust was liable for “administrative costs of the estate when the assets of the estate are insufficient.” The court cited In re Stevenson, 648 A.2d 559 (Pa. Super 1994), which involved “in trust for” bank accounts, for the proposition that a “tentative trust” or “Totten trust” may be inviolate to cover an estate’s administration expenses. The court then used Black’s Law Dictionary’s definition of a Totten trust to conclude that a revocable trust under which the settlor could withdraw funds at will was a Totten trust. Hence, the court made a leap in logic on two counts - first that the creditor rules of a Totten trust apply to an inter vivos revocable trust and second that the ability to tap into a revocable trust to pay an estate’s administration expenses applies as well to inheritance tax notwithstanding the provisions of the statute creating transferee liability for the tax. Annot. Fiduciary Review Dec. 2001.

FLP Valuation Upheld on Burden Shifting

In Estate of Elma M. Dailey v. Commissioner, TC Memo 2001-263 (2001), the Tax Court allowed a 40% discount for gifts of limited interests in a partnership that held only publicly traded securities. The donor created an FLP with her son. She held a 1% general partnership interest and a 98% limited partnership interest, with her son owning a 1% limited partnership interest. The son did not contribute any property for his interest. In 1992, the donor transferred a 45% limited partnership interest to her son and a 15% interest to his wife. She placed her remaining 38% in her revocable trust. In 1995, her general partnership interest was converted to a limited interest and the son became general partner. She died in 1997.

The IRS disputed the size of the minority and marketability discounts. The case appears to have involved a battle of mediocre valuation experts. The parties stipulated that under IRC section 751(a), the taxpayer introduced credible evidence, and the IRS had the burden of proof on the valuation issue. Both parties’ experts compared the FLP to closed-end mutual funds, which trade at a discount to net asset value. The taxpayer’s expert, citing published data, opined that the aggregate discount was 40% for lack of marketability, control, and liquidity and testified that he considered the significant amount of unrealized capital gains relating to Exxon stock held in the partnership. The IRS expert, on the other hand, relied in part on an unpublished study that he coauthored. In a revised report submitted at trial, he increased the marketability discount purportedly substantiated by his unpublished study from 12.5% to 14.1%. The IRS expert opined that an aggregate discount of between 13.51% and 15.72% should be applied. At trial, the IRS expert testified that he could not recall reviewing the Agreement and, although he believed that unrealized capital gains continued on page 19
Tax Update, continued

are “an important source of discounts”, he did not review the documents to determine if the FLP had any such gains. The court concluded that the IRS expert’s testimony was contradictory, unsupported by the data, and inapplicable to the facts. The court noted that “[although neither expert was extraordinary, petitioners’ expert provided] a more convincing and thorough analysis than respondent’s expert.” The court then concluded that an aggregate marketability and minority discount of 40% was warranted and applicable.

Discount for Nonvoting Stock Reduces Charitable Deduction

In Schwan Estate v. Commissioner, T.C. Memo 2001-174 (2001), the decedent left to a private foundation two-thirds of his voting stock and two-thirds of his nonvoting stock. The foundation had agreed with the corporation during the decedent’s lifetime that the corporation would redeem the foundation’s stock for its value as determined for estate tax purposes. What was unclear was whether the agreement pertained to only the voting stock or all of the stock left to the foundation. After his death, an amendment to the agreement clarified that it pertained to both the voting and nonvoting shares and set the purchase price at $869 million. The executors valued the stock at that amount in the gross estate and took a charitable deduction for the full value of the bequest to the foundation. On a motion for summary judgment, the Tax Court refused to rule as a matter of law that the nonvoting shares had the same value for charitable deduction purposes as they had for gross estate purposes. The court reasoned that the stock is valued for gross estate purposes based on what transfers at death. However, for purposes of the charitable deduction, the court ruled that it was a question of fact as to whether the redemption agreement required that only the voting shares be redeemed or all of the shares be redeemed.

Step Transaction Adds Gift Taxes to Gross Estate/Administration Expenses Deductible Without Reducing Marital Deduction

In Betty Brown v. U.S., 88 AFTR2d ¶2001-6665 (C.D. Cal. 2001), a decedent gave his wife $3.1 million, deposited into her separate bank account, in order for her to make a gift to an irrevocable trust owning a $10 million insurance policy on her life. The decedent then made a $1.4 million transfer to his wife to enable her to pay the gift taxes for the transfer to the trust, which she did. Several months thereafter, the decedent died with a $180 million estate that qualified in full for the marital deduction. Hence, the estate took the position that no estate tax was due.

The district court decided that, at least in substance over form, the transfer to the trust and the gift taxes were paid by the decedent and therefore the gift taxes should be included in his gross estate. Having lost its first argument, that the $1.4 million should not be included in the decedent’s estate, the estate then sought at least a partial refund of the payments made to the IRS on two additional grounds. First, it contended that the amount of any tax deficiency should be offset by excess expenses incurred in administering the estate, arguing that actual administrative expenses exceeded the estimated expenses claimed on the original estate tax return by an amount that exceeds the alleged tax deficiency. Thus, the estate argued that it should not have been required to pay any estate taxes. Second, the estate claimed that payment of interest to the IRS and to the state on its tax payments should be allowed as an administrative expense without reducing the marital deduction. The court ruled that the deduction of administrative expenses chargeable to principal of the estate reduced the marital deduction on a dollar for dollar basis. However, citing Estate of Hubert, 520 U.S. 93 (1997), it ruled that some $67,246.84 of administrative expenses charged to income and the interest payments did not constitute a material limitation on the spouse’s interest and therefore did not reduce the marital deduction.

* * *

Marriage has many benefits and pitfalls. Among the benefits is the federal estate tax marital deduction. Among the pitfalls is the right of a surviving spouse to claim a one-half intestate share or a one-third elective share. In planning estates, we sometimes are faced with the question of whether our clients are married - regardless of how they view the situation. This has become especially true for older couples with grown children.

Common Law Marriage

Pennsylvania recognizes the doctrine of common-law marriage, but the Pennsylvania Supreme Court has noted that “while common-law marriages may be tolerated, they are not encouraged.” Staudenmayer v. Staudenmayer, 552 Pa. 714 (1998). The test of a common-law marriage is that there be parties that are competent to enter into a marriage who intend to be married. Technically, cohabitation is not required, but for practical purposes, no common-law marriage can be found without intent, cohabitation and reputation. To prove intent, the parties must exchange words “in praesenti.” These are words spoken...
Tax Update, continued

in the present tense by both parties with the specific purpose of establishing the marriage relationship (such as “now we are married”).

In the recent case of Cicchello v. Koyen, 22 Fiduc. Rep. 2d 39 (O.C. Lycoming 2001), a woman brought a divorce action against a man whom she claimed was her common law spouse. In order to obtain health insurance, the parties had signed an affidavit stating that they “affirm, under penalty of perjury, that we have expressly agreed to and entered into a common-law marriage. Pursuant to this common-law marriage, we established the relationship of husband and wife. We hold ourselves out to the community as husband and wife and have cohabited for three (3) years.” The parties never filed joint income tax returns nor did they own assets jointly. Noting that both parties are alive and capable of testifying as to the existence of words in præsenti, the court refused to find a common-law marriage without credible evidence that the parties exchanged such words.

Estate planners, however, should keep in mind that in cases involving decedents where one of the parties cannot testify, if there is evidence of constant cohabitation and reputation of marriage, a presumption arises that words in præsenti were exchanged. Consequently, the existence of a common-law marriage in estate matters remains a lurking danger or benefit, depending on whether the estate desires a marital deduction or the disallowance of an elective share claim. Subject to the ethical issues relating to representing multiple parties, the estate planner is well advised to have cohabiting clients clarify their non-marital status in writing.

RULINGS

Charitable Deduction Allowed Upon Exercise for Pledge of Stock Option

In PLR 200202034, the IRS ruled that a corporation may take a charitable deduction for a stock option pledged to a private foundation. The corporation pledged the option to the foundation which when exercised would allow the foundation to purchase a specified number of shares of common stock at the closing price of the stock on the date of the pledge agreement. The option provided that it could be assigned by the foundation to an unrelated 501(c)(3) organization. The foundation proposed to sell the option to another charity at a discount. The IRS relied on Rev. Rul. 75-348, 1975-2 C.B. 75, which holds that a corporation that pledges to sell shares of its common stock at a specified price to an educational organization is entitled to a charitable contribution deduction, in the taxable year the pledge is exercised, for the excess of the fair market value of the shares on the date the pledge is exercised over the exercise price. The Ruling noted where a charitable contribution is made in property other than money, IRC Reg. section 1.170A-1(c) provides, in part, that the amount of the deduction is the fair market value of the contributed property at the time of the contributions.

Disclaimer Valid if Made Nine Months After Learning of the Interest

In PLR 200202036, a father left a will with a marital and credit shelter trust. The credit shelter trust provided that at the mother’s death, the principal was payable to the descendants of the father. The taxpayer was unaware of her father’s will until after the death of her mother. Citing IRC Reg. section 25.2511-1(c)(2), the IRS ruled that a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer. In this case, the refusal was made within nine months of the mother’s death and the taxpayer gaining knowledge of the transfer under the father’s will.

Automatic Allocation of GST Exemption for Direct Skips

In PLR 200202002, the IRS ruled that notwithstanding the failure to allocate GST exemption on a gift tax return, the automatic allocation for direct skips under IRC section 2632(b)(1) applied to keep the inclusion ratio of a trust for grandchildren at zero. The donor transferred assets to a trust for two grandchildren subject to Crummey powers equal to the full amount of the contributions. The trust provided that income and principal were to paid in the discretion of the trustee to and among the grandchildren until the first to occur of the death of the grantor and his spouse or a specified date. At that point, the trust was to be divided into separate shares for the individual grandchildren and held for their lives, each having a power of appointment limited to descendants of the donor.

The donor’s gift tax returns did not allocate any of her available GST exemption to the trust. The IRS reasoned that the trust was a “skip person” because all of the interests were held by skip persons. Therefore, the transfers to the trusts were direct skips and the automatic allocation rules of section 2032(b)(1) applied. What the ruling does not stab is whether the contributions to the trust exceeded the 5 and 5 amounts applicable for a lapse of a general power of appointment under section 2514(e). If they did, then to the extent of the excess over the 5 and 5 amount, the grandchildren were the

continued on page 21
Tax Update, continued

transferors for GST purposes and the assets would be includable in their estates under section 2036.

Life Insurance Proceeds in Irrevocable Trust May be Used to Pay Estate Taxes

In PLR 200147039, proceeds from an insurance policy on the joint lives of a married couple that was owned by an irrevocable trust were not includable in the gross estate of the last spouse to die. Under the trust instrument, the trustee is not required to pay any amounts to the estate of either or both of husband and/or wife in satisfaction of estate debts or liabilities of any kind. The trustee may, however, in its sole discretion, pay the estate tax, inheritance tax, or any other tax or expense due by reason of husband and/or wife’s death, but shall be under no compulsion to do so. Because the trustee had the discretionary power to use the proceeds of life insurance to pay federal estate tax in the wife’s estate, the proceeds were not received by the trustee subject to the estate tax obligation. Therefore, the proceeds would not be considered received by the estate under Reg. section 20.2042-1(b).

Revenue Procedure Allows IRS to Disregard QTIP Election

In Rev. Proc. 2001-38, 2001-24 I.R.B. 1335 (June 11, 2001), the IRS provided relief for surviving spouses and their estates in situations where a predeceased spouse’s estate made a qualified terminable interest property election under section 2056(b)(7) that did not reduce the estate tax liability of the estate. By treating the election as a nullity, the property will not be subject to transfer tax with respect to the surviving spouse. In some cases, a QTIP election was made when the taxable estate (before allowance of the marital deduction) was less than the applicable exclusion amount under section 2010(c). The QTIP election was not necessary, because no estate tax would have been imposed whether or not the QTIP election was made. In other cases, the decedent’s will provided for a credit shelter trust to be funded with an amount equal to the applicable exclusion amount under section 2010(c), with the balance of the estate passing to a marital trust intended to qualify under section 2056(b)(7). The estate made QTIP elections for both the credit shelter trust and the marital trust. The QTIP election for the credit shelter trust was not necessary, because no estate tax would have been imposed whether or not the QTIP election was made for that trust. In these situations, as a consequence of the unnecessary QTIP election, the property subject to the election would be included in the surviving spouse’s gross estate under section 2044(a), or if that spouse disposes of the income interest, would be subject to gift tax under section 2519. Further, the surviving spouse would, in the absence of a reverse QTIP election under section 2652(a)(3), be treated as the transferor of the property for generation-skipping transfer tax purposes under section 2652(a).

The Rev. Proc. goes on to state that the IRS will disregard the election and treat it as null and void for purposes of sections 2044(a), 2056(b)(7), 2519(a), and 2652. The property for which the election is disregarded under this procedure will not be includable in the gross estate of the surviving spouse under section 2044, and the spouse will not be treated as making a gift under section 2519 if the spouse disposes of the income interest with respect to the property. Further, the surviving spouse will not be treated as the transferor of the property for generation-skipping transfer tax purposes under section 2652(a). To establish that an election is within the scope of the revenue procedure, the taxpayer must produce sufficient evidence to that effect. For example, the taxpayer may produce a copy of the estate tax return filed by the predeceased spouse’s estate establishing that the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. Such information, including an explanation of why the election should be treated as void should be submitted either with the Form 706 filed for the surviving spouse’s estate, or with a request for a private letter ruling submitted at any time prior to filing that Form 706.

JOIN A COMMITTEE

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:

Norman E. Donoghue, II
Dechert
4000 Bell Atlantic Tower
1717 Arch Street
Philadelphia, PA 19103
(215) 994-2539

Name:

Address:

Committee Preferences:
First:
Second:
Third:
Philippines Orphans’ Court Forms
Now on Court Website --
Revised Computer-Ready Audit Forms In Use

By MARY JANE BARRET
CHAIR OF RULES AND PRACTICE COMMITTEE

Petitions for Adjudication and Statements of Proposed Distribution, the forms required to accompany accounts filed for audit in the Philadelphia Orphans’ Court, have been changed, both in form of preparation and in substance. Since mid-March, 2002, the Philadelphia Court website (www.courts.phila.gov) has permitted practitioners to click the “Forms” listing on the left of the homepage and download newly revised petitions for completion on word processors, obviating the use of typewriters and the attachment of lengthy riders. The forms are or will be available in WordPerfect, Word and PDF formats. The posting of the forms constituted their official promulgation by the Court, and represented the culmination of several years’ efforts by the Rules and Practice Committee and several Section chairs, as well as the considerable efforts of the Administrative Judge and his staff.

The revised forms will permit the user to type in the information requested, and will expand or contract as needed. The attorney is asked to sign a certification at the end of the petition that it is a true and accurate reproduction of the form petition authorized by the Orphans’ Court and that no changes to the form have been made beyond the responses. The Court will continue to accept the old pre-printed audit forms for the time being, and the Clerk’s office will also download the new forms for those lacking internet access who request them.

Both the appearance and content of the audit forms are revised and updated. No longer are there separate forms for “Wills” and “Intestates,” but there is now one form for a “Decedent’s Estate.” Similarly, a single petition pertaining to “Trusts” replaces the two petitions for “Trusts Inter Vivos” and “Testamentary Trusts.” The form for “Guardianship of Incapacitated Person” corrects the form for guardians of an “incompetent” (long superseded terminology); as before, this form should be modified as needed for guardianships of minors.

A totally new form titled “Principal’s Estate” has been created for Petitions for Adjudication filed in conjunction with accounts of agents or attorneys-in-fact acting pursuant to a power of attorney, recognizing the increasing frequency with which these accounts are now being filed pursuant to court order.

Particular care was taken by the committee in its revisions to make the forms user-friendly to the non-Orphans’ Court lawyers, giving citations to relevant rules or other sources.

Until recently, the Court website carried only a few Orphans’ Court forms, but now lists most of the available forms for downloading, including the Cover Sheet, form for Appeal from the Register of Wills, Annual Reports for Guardians of the Person and Estate, Preliminary Audit Statement, Account Filing Checklists, Checklist for Compromise of Wrongful Death and Survival Action, Guardian’s Inventory, Notice of Claim, Entry of Appearance and Notice of Charitable Gift.

With the ability to utilize both computer and internet technology, Orphans’ Court practitioners should experience increased ease and efficiency in their practices. ☞
Update: Pennsylvania’s New Section 529 Plan

By AMY NEWMAN
SCHNADER HARRISON SEGAL & LEWIS LLP

Pennsylvania’s new Section 529 Plan, slated to become operational this spring, will be the state’s second college savings program created pursuant to Section 529 of the Internal Revenue Code of 1986, as amended (“I.R.C.”). According to an announcement in January by State Treasurer Barbara Hafer, the new plan will be managed by Delaware Investments. While the current Tuition Account Program (“TAP”) allows families to purchase future college credits at today's prices by guaranteeing a rate of return that keeps pace with tuition increases, the new plan will be more like a traditional investment plan and will allow families to take advantage of stock market performance by evaluating their risk tolerance and selecting a suitable investment strategy.

According to Robert Gentzel, Director of Communications for the Pennsylvania Treasury Department, the new plan will offer nine investment options based on underlying mutual funds, and families will be able to mix and match among the funds to further tailor their portfolio to their needs. The investment options will include two age-based plans in which the investments will become more conservative as the child approaches college age. The more aggressive of the age-based plans will allow the investments to remain in equities for a longer period of time. In addition, there will be five investment options based on a mixture of equities and fixed income: (1) a stable value fund, (2) a conservative fund with 40% equities, (3) a balanced fund with 60% equities, (4) an aggressive fund with 80% equities and (5) the most aggressive fund with 100% equities. Finally, the new plan will include two socially-responsible funds which will be managed by Calvert Group, Ltd., a leader in socially-responsible investing. Pennsylvania, one of the only states to offer socially-responsible funds as an investment option for Section 529 plans, will offer both a Calvert stock fund and a Calvert bond fund.

The new plan is expected to become operational this spring, but no date has been announced and fees and administrative details have not yet been finalized. Families will be able to participate in the new plan by contacting their broker, by using a toll free number or by visiting the state’s website. Residents of any state will be able to participate in the new plan, and following last year’s tax law changes, growth on the plan assets will be free of federal income tax for all participants. In addition, state tax law provides that growth will be free of state and local taxes for participants who are Pennsylvania residents.

Mr. Gentzel anticipates that families will initially be able to contribute a maximum of $260,000 per beneficiary to the new plan. The Treasury Department arrived at this amount by calculating the cost for five years of undergraduate expenses and two years of graduate expenses at the University of Pennsylvania. The $260,000 cap on contributions will increase as the price of education increases. Tax-free distributions under the new plan may be used for tuition and any “qualified higher education expense,” as defined by the I.R.C. and its accompanying regulations, for a beneficiary's attendance at Pennsylvania schools or out-of-state institutions.

The state had originally selected Mellon Financial Corp. to manage the new plan but solicited new proposals when Mellon sold its banks last fall. Delaware Investments is a Philadelphia-based company and is a member of the Lincoln Financial Group and both of these points factored favorably in the selection process.

For information about the current TAP program and for press releases concerning the new plan, please visit www.patap.org.
Tax Committee Meetings of October and December 2001

At the October and December 2001 meetings of the Tax Committee of the Probate Section of the Philadelphia Bar Association, representatives from the Internal Revenue Service and the Pennsylvania Department of Revenue spoke about various subjects. With permission from the Tax Committee, the following has been taken from the minutes of those meetings.

The representatives from the Pennsylvania Department of Revenue, who spoke at the October 2001 meeting, were John C. Murphy, Chief of the Inheritance Tax Division, and Paul Diebert, Valuation Manager. They discussed the following:

With respect to legislative issues, no rate reductions are on the horizon given the current budget deficit and decreasing collections due to declines in the value of stocks.

There is apparently no intent at this juncture to increase inheritance tax rates to replace lost estate taxes due to the phase-out of the state death tax credit for federal estate tax purposes.

With respect to valuation periods during the close of the market following September 11, Pennsylvania will follow the federal position.

The turn-around time on inheritance tax returns is 90% in 90 days. Spousal compromises and closely held business interest cases are taking longer.

Regarding litigation settlements, it is the Department’s position to value claims based upon actual litigation proceeds, and abate the interest that would have accrued on the underpayment.

Several counties are adopting the requirement that the Department approve the allocation between wrongful death and survival actions in litigation settlements; however, the Department will not upset any such allocation by a jury. Practitioners must send a copy of the proposed settlement to the Department, which will send its approval, or lack thereof, to the attorney and to the court.

Assessment of tax on assets that will be sold during administration can be suspended. On Schedule A, indicate the desire to suspend assessment, and do not carry the estimated value of the asset to the recapitulation. If this is done, selling expenses can reduce the ultimate value for inheritance tax purposes.

At the Tax Committee’s December 2001 meeting, the guest speakers were John Darazin and Penelope Green from the Internal Revenue Service’s Estate and Gift Tax Group. Mr. Darazin discussed recent valuation cases and noted that IRS agents are going to strongly resist discounts on built-in gain. In addition, the IRS views the case of Strangi v. Commissioner, as a bad FLP decision. Although the Tax Court did not consider it because of procedural issues, the IRS hopes their §2036 argument will win on appeal. A dissenting judge agreed with the IRS on the “gift on creation theory” that wealth evaporated upon creation of the family limited partnership, therefore, there must have been a gift somewhere in the transaction. The IRS is not giving up on the gift on creation theory. Mr. Darazin thinks the appellate court will find that the family limited partnership was window dressing and had no business purpose.

Penelope Green then discussed changes at IRS Service Centers. Ms. Green acts as liaison between the IRS and taxpayers on estate and gift tax issues. As of January 1, 2002, estate and gift tax returns are to be filed in Cincinnati. Do not file anywhere else, or the return may get lost. Mistakes that will result in audits include failing to report the basis of gifted assets and failing to report the dates of gifts. Do not use “VARIOUS.” In July 2002, §6166 returns will be transferred to Cincinnati for filing. Ms. Green’s telephone number is (215) 516-2509. Her assistant, Sabrina Bennett, can be reached at (215) 516-3946. They are your contacts for status inquiries.
Report of the Chair, continued from Page 1

On the legislative front, the officers and the Legislative Committee led by Kathleen Stephenson have been following closely the progress of Senate Bill 1014, the Principal and Income Act. The importance of this bill cannot be overestimated. It has the potential to attract trust business to Pennsylvania with the 4% Unitrust conversion provision and this possibility ought certainly to make current trust income beneficiaries much happier. The bill was drafted by our own Bob Freedman, a veteran of legislative wars, having served over twenty years as principal draftsmen for the Advisory Committee on Trusts and Estates of the Joint State Government Commission. The bill appears to be moving in the right direction through the Judiciary Committee of the State Assembly and we are guardedly hopeful of a pre-summer recess passage.

Howard Verbofsky and I enjoyed a January PBA leadership "retreat" at Seaview outside of Atlantic City. The retreat focused on both the "Century 3" festivities as well as the drain on our overall Association's membership caused by the region's changing demographics. The retreat drew the core leadership of the Bar and reminded me how energetic and truly dedicated the Association’s many volunteer leaders are. This is a Bar with great traditions and outstanding leadership over the past century.

I was also privileged to have the opportunity in late January to speak before the monthly meeting of the Corporate Fiduciaries Association. This distinguished group brings together the many fine corporate fiduciaries that this populous and relatively wealthy Greater Philadelphia region has attracted. Many of our Section’s members and leaders now reside in the ranks of corporate fiduciaries. We hope to work jointly together with our colleagues in the banks and trust companies to achieve common goals for the practice. Several initiatives are already under way.

Lastly, I have to mention once again the old saw about how the "guts" of the Section is the work of its many committees. It is so true and such truisms, even though cliche, bear repetition. On behalf of the Section, I thank again the Committee chairs, Judith Stein (Education), Susan Collings (Publications), Andrea Lawrence (Taxation), Kathleen Stephenson (Legislative), Deb Speyer (Elder Law), Mary Jane Barrett (Rules and Practice) and Andrea Hyatt Callan (Public Service), who month after month keep the programs going which so stimulate our membership and continue our tradition of "giving back" to the profession we all enjoy practicing.

If you are not already on a Section committee, I urge you to join in the fun of improving the practice. ©