Report of the Chair

By NED DONOGHUE

On June 4, the Probate and Trust Law Section held its quarterly meeting followed by an excellent and timely CLE entitled "Reinventing Income, Rethinking Trust Distributions" covering the new Principal and Income Act. Section stalwart and my tech- and tax-savvy fellow officer, Julia Fisher, Young Lawyers Division representative to the Executive Committee, Tom Hiscott, and New York's Libby Anderson gave outstanding presentations on this complex new Act, and we are grateful for their hard work and valuable insights. I would like to thank Judith Stein and her hard-working Education Committee for being so prescient to plan this fine course far in advance but right on the heels of the new law's enactment. Next time there’s a bill we’re interested in, the Section will ask Judith to plan a CLE on it in advance of passage.

Mark your calendars now for the upcoming Section events including Tuesday, October 1 “Staying Out of Trouble”, a 2-hour Ethics CLE, and Tuesday, December 3 for our Annual Meeting and special CLE with our annual reception to follow.

Now for news of our other important Section activities. Our Public Service Committee will be starting a new program in the next few weeks to match up lawyers in our section with pro bono matters that involve estate planning, estate administration, guardianship and other fiduciary law issues. The program will entail a monthly e-mail posted to our Section’s list serve which will list six (6) pro bono cases for which the assistance of volunteer attorneys is presently needed. The e-mail will include instructions on how to volunteer to handle a case. The Committee will receive information regarding pro bono cases from the following legal service organizations:

- Philadelphia Volunteers for the Indigent Program
- The Legal Clinic for the Disabled
- Senior Citizen JUDICARE Project
- Philadelphia Volunteer Lawyers for the Arts (PVLA)
- The Center for Lesbian and Gay Civil Rights
- AIDS Law Project of Pennsylvania

If you know of any other pro bono organizations that could use this program to publicize their need for legal assistance on probate and trust matters, please contact the chair of the Public Service Committee, An continued on page 25

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Planning For Education Expenses: A Review of Tax-Favored Savings Tools

By KAREN M. STOCKMAL, ESQUIRE, PEPPER HAMILTON LLP
and AMY NEWNAM, ESQUIRE, SCHNADER HARRISON SEGAL & LEWIS LLP

As of January 1, 2002, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), enhanced the already significant benefits of Qualified Tuition Programs or "Section 529 plans" and made them one of the most talked about financial planning tools available. Encouraging investors to save for college expenses using tax-deferred growth and tax-free qualified distributions, a Section 529 plan can be a powerful financial planning tool. In addition, there are other tools available for education planning which may be used to supplement or supplant a Section 529 plan, depending on an investor's particular circumstances and goals. The third and final in a series of Probate and Trust Law Section Newsletter articles on Section 529 plans¹, this article will explore some of these other tools, including Coverdell Education Savings Accounts, Section 2503(e) Tuition Payments, UTMA/UGMA Custodial Accounts, Crummey Trusts and Section 2503(c) Minor’s Trusts, and will compare these tools to the much-publicized Section 529 plans.

Section 529 Plans

Briefly, Section 529 plans, so-named because of their creation under Section 529 of the Internal Revenue Code of 1986, as amended ("I.R.C."), allow an investor to contribute funds toward the qualified higher education expenses of a designated beneficiary through a school or state-sponsored Tuition Credit Program² or a state-sponsored Savings Account Program.³ In a Tuition Credit Program, an investor purchases tuition credits from a Section 529 plan at current prices thereby entitling the designated beneficiary of the plan to use the credits in the future. In a Savings Account Program, an investor makes contributions to a Section 529 plan account for future distribution to the designated beneficiary to meet his or her higher education expenses.

Section 529 plans offer investors many benefits. First, the earnings are exempt from federal income taxes; accordingly, the accounts grow tax-deferred. Second, contributions can be made so as to be exempt from Federal Estate and Gift Taxes as well as from the Generation Skipping Transfer Tax. In addition, a contributor may make an election to "front-load" five years of annual exclusion gifts into the initial contribution.⁴ Third, most Section 529 plans allow the contributor to reacquire the funds at any time, subject to a penalty, thereby effectively allowing an investor to make a completed gift and then take it back. Fourth, most Section 529 plans allow the contributor to change who will receive the funds ("the designated beneficiary") and when and in what amounts distributions are


² States with Tuition Credit Programs: Alabama, Colorado, Florida, Illinois, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, Nevada, New Mexico, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, Washington, West Virginia.

³ States with Savings Account Programs: Alabama (planned but not operational as of 5/1/02), Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida (planned but not operational as of 5/1/02), Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania (operational as of 7/02), Rhode Island, South Carolina, Tennessee, Texas (planned but not operational as of 5/1/02), Utah, Vermont, Virginia, Washington (planned but not operational as of 5/1/02), Washington D.C. (planned but not operational as of 5/1/02), Wisconsin, Wyoming.

⁴ I.R.C. §529(c)(2)(B).

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Education Expenses, continued

made. Fifth, there are no age or income restrictions on who may participate in a Section 529 plan, either as a contributor or as a designated beneficiary. Sixth, and perhaps most importantly from a tax perspective, as of January 1, 2002, withdrawals made to meet the qualified higher education expenses\(^5\) of the designated beneficiary are completely exempt from federal income taxes.\(^6\)

Nevertheless, the benefits of a Section 529 plan come with certain restrictions. First, all contributions to a Section 529 plan must be in cash.\(^7\) Second, a 10% federal penalty will be assessed on the earnings portion of all non-qualified distributions.\(^8\) Third, neither the account owner nor the designated beneficiary are allowed to direct investments; however, the account owner may select from one of a number of investment strategies offered by the Section 529 plan and may change his or her selection once every twelve months.\(^9\) Fourth, the plan must not allow the assets to be used as security for any loan.\(^10\) Finally, each Section 529 plan must prevent contributions that are in excess of those necessary to provide for the qualified higher education expenses of the designated beneficiary.\(^11\)

**Coverdell Education Savings Accounts**

Like Section 529 plans, Coverdell Education Savings Accounts (formerly known as “Education IRAs”) were made significantly more attractive by EGTRRA. The new law increased the annual contribution limit to a Coverdell Account from $500 to $2,000 per beneficiary, subject to certain phaseout limitations based on the donor’s income,\(^12\) and it broadened the definition of “qualified education expenses” to include not only higher education expenses (as defined under Section 529) but also elementary and secondary education expenses. In addition, the existing restriction on making contributions to both a Section 529 plan and a Coverdell Account for the same beneficiary in the same year was eliminated. Like Section 529 plans, Coverdell Accounts allow tax-deferred growth and tax-free distributions for “qualified” expenses.\(^13\) Contributions to a Coverdell Account may qualify for the annual gift tax exclusion,\(^14\) and as with a Section 529 plan, will be included in the designated beneficiary’s estate but not the donor’s. Like a Section 529 plan, contributions to a Coverdell Account must be in cash.\(^15\) However, unlike a Section 529 plan where investors choose from limited “menus” of investment options, an investor may retain complete control of Coverdell Account investments, a factor many donors find appealing.

Despite the improvements included in EGTRRA, Coverdell Accounts are still limited by the annual $2,000 contribution cap as well as by certain age restrictions.\(^16\) Contributions may be made to a Coverdell Account only until the designated beneficiary reaches age 18 and any funds remaining in the Coverdell Account that have not been distributed or rolled over must be distributed to the designated beneficiary at age 30, at which point the earnings portion of the distributed funds will be subject to both federal income tax and a 10% penalty tax.\(^17\)

\(^5\)“Qualified higher education expenses” include tuition, fees, books, supplies and equipment required for the enrollment or attendance of a designated beneficiary at an eligible education institution. I.R.C. § 529(c)(3). Basically, the key is that only “required” expenses are considered qualified. In addition, as of January 1, 2002, reasonable room and board expenses are considered qualified higher education expenses.

\(^6\) This provision is subject to expire, or “sunset,” on December 31, 2010, at which point the earnings portion of each qualified withdrawal will be taxed to the designated beneficiary at his or her income tax rate.

\(^7\) I.R.C. §529(b)(2).

\(^8\) I.R.C. §529(c)(3)(A).

\(^9\) I.R.C. §529(b)(4). See also, IRS Notice 2001-55.

\(^10\) I.R.C. §529(b)(5).

\(^11\) I.R.C. §529(b)(6). As a practical matter, most plans have maximum account amounts which are indexed to equal five years of expenses at the most expensive school in the sponsoring state. Maximums range from $114,543 to $305,000.

\(^12\) I.R.C. §530(b)(1)(A)(ii) and I.R.C. §530(c)(1). Contributions are phased out completely for single taxpayers with adjusted gross income over $110,000 and for married taxpayers filing jointly with adjusted gross income over $220,000.

\(^13\) I.R.C. §530(a).

\(^14\) I.R.C. §2503(b).

\(^15\) I.R.C. §530(b)(1)(A)(i).

\(^16\) I.R.C. §530(b)(1)(A)(i).

\(^17\) I.R.C. §530(b)(1)(E) and I.R.C. §530(d)(4)(b)(i).
Education Expenses, continued

For these reasons, it is unlikely that Coverdell Accounts will ever be as widely-used as Section 529 plans for college planning.

However, Coverdell Accounts are an important tool for education planning in general. For individuals who plan to incur significant expenses in connection with their children’s elementary and secondary educations, a Coverdell Account offers significant tax savings for these expenses. Taking advantage of the tax-free growth offered by each tool, a donor could create a Coverdell Account to pay for elementary or secondary education expenses and a Section 529 plan to pay for college expenses; however, since both contributions are considered annual exclusion gifts under I.R.C. §2503(b), any amount that is contributed to a Coverdell Account will necessarily reduce the amount which may be contributed to a Section 529 plan in that year without using the donor’s lifetime gift tax exclusion.

As with all of the education planning tools, donors will need to plan ahead in order to coordinate the most beneficial strategy for their circumstances. For example, middle-income taxpayers who are eligible to claim the various credits and deductions for education expenses on their income tax returns, such as the Lifetime Learning Credit and the Hope Scholarship Credit, must be aware that they cannot claim such credits for education expenses paid for by Section 529 plan distributions or Coverdell Account distributions. Therefore, taxpayers eligible for these credits should consider paying some educational expenses with their own assets to make use of the credits and using the Section 529 plan and/or Coverdell Account distributions to pay for the remaining expenses.

Section 2503(e) Tuition Payments

I.R.C. Section 2503(e) allows a donor to make tuition payments directly to an educational organization on behalf of a beneficiary without such payments being considered a gift. In order to qualify for this treatment, Section 2503(e) payments must be made directly to a “qualifying educational organization” as defined by the I.R.C. and may be used only for tuition expenses. For a donor who routinely takes full advantage of his or her annual gift tax exclusion but who wants to further reduce his or her estate while paying for a donee’s education, Section 2503(e) payments can be an important financial planning tool.

The benefits of Section 2503(e) payments are that there are no contribution limits, there are no age or income restrictions for the donors or beneficiaries, the payments are not restricted to higher education and a donor retains use and investment control of the funds until they are paid to the educational organization. The drawbacks to Section 2503(e) payments are that the payments may be made only for tuition expenses and are fully subject to both federal income tax and estate tax while in the donor’s control. In addition, unlike Section 529 plans, the donor cannot prepay the tuition expenses; he or she must live until the tuition bills are due.

However, when used in connection with a Section 529 plan, Section 2503(e) payments offer a donor flexibility and leverage. For example, a grandparent with a young grandchild can invest in a Section 529 plan today and reduce her estate. When her grandchild reaches college age, she can then make the tuition payments to the college under Section 2503(e) to further decrease her estate and direct that the Section 529 plan assets either be used towards non-tuition-related qualified expenses or be rolled over for other individuals. If, however, our grandparent has died in the interim, she has not only reduced her estate by the amount in the Section 529 plan but she has also successfully assisted with the future college education expenses of her grandchild.

UTMA/UGMA Custodial Accounts

An education planning strategy already familiar to many donors is a Uniform Transfers to Minors Act (“UTMA”) account.18 Pursuant to Pennsylvania’s statute, a donor may create an UTMA custodianship which vests property in a minor beneficiary subject to the control of the custodian.19 One of the benefits of an UTMA account is that the donor is not limited to cash contributions but may contribute any type of property — real or personal, tangible or intangible. In addition, the use of funds held in an UTMA account is not limited to “qualified education expenses,” but rather may be extended to a variety of purposes. For many donors, however, a significant limitation of an UTMA account is the requirement that the custodianship terminate when the beneficiary reaches age twenty-one.20

18 Also known as a Uniform Gifts to Minors Act (“UGMA”) account in some states.
19 20 Pa. C.S. § 5301 et seq.
20 Section 5321 of Pennsylvania’s new Principal and Income Act does not allow for a delay in the transfer of custodial property beyond age 21 for custodianships created by irrevocable gift. 20 Pa. C.S. § 5321(e).

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In addition, because UTMA accounts vest the ownership of the property in the beneficiary, they do not offer donors the flexibility to change beneficiaries that Section 529 plans and Coverdell Accounts offer. The combination of these factors is a serious drawback for many donors who are reluctant to allow the beneficiary to gain control of the assets at age twenty-one.

Investors who wish funds to be used for non-educational expenses and who do not plan to contribute cash should consider an UTMA account as one financial planning option. However, investors who plan to gift assets to minors for the purpose of meeting education expenses should consider using a Section 529 plan and/or a Coverdell Account because UTMA accounts do not offer the same tax-free benefits.

_Crummey_ Trusts

A _Crummey_ trust, named for the well-known case _Crummey v. Commissioner_,21 is an often-utilized education planning strategy. A donor is able to establish an irrevocable trust and, by giving the beneficiary the right to withdraw a portion of the annual contributions made to the trust, qualify that portion of the contributions for the gift tax annual exclusion. The donor is then able to authorize any type of distribution standard he or she chooses, specify the purposes for which discretionary distributions can be made and specify when the trust principal is to be distributed.

By creating a _Crummey_ trust, donors can establish a fund that is intended primarily to pay for future education expenses but which may also be broad enough to pay for a variety of other situations that may arise and that may be appropriate occasions for trust distributions, such as medical expenses. Consequently, a _Crummey_ trust may be drafted to provide greater flexibility than either a Section 529 plan or a Coverdell Account. Other benefits of a _Crummey_ trust are that contributions are not limited to cash and that donors, acting as trustees, may retain some control over the trust investments. Unlike a Section 529 plan or a Coverdell Account, however, _Crummey_ trusts do not offer donors the advantage of tax-deferred growth and tax-free distributions. Instead, a _Crummey_ trust is a taxable entity which may be required to file annual income tax returns and to pay the tax at rates higher than individual rates. Another drawback to the _Crummey_ trust is the administrative costs, which can include legal drafting to create the trust and ongoing fiduciary fees. Section 529 plans, Coverdell Accounts and UTMA accounts require no such expenses.

Finally, _Crummey_ trusts require that the beneficiary receive notice whenever a contribution is made to the trust. Providing such notice can be both an administrative expense and a concern for investors who want accounts kept private during a beneficiary’s minority or thereafter. Section 529 plans do not require that notice be given to a designated beneficiary at any age. Coverdell Accounts also do not require notice but because they are held in the name of the beneficiary, an adult beneficiary would receive periodic statements and would thus be aware of contributions. Similarly, an UTMA account does not specifically require notice, but the account must be turned over to the beneficiary upon reaching the age specified in the governing state statute, thus effectively giving notice of the gift.

Section 2503(c) Minor’s Trust

I.R.C. Section 2503(c) allows a donor to make gifts in trust to a beneficiary who has not yet attained twenty-one years of age and to qualify those gifts for the gift tax annual exclusion. Similar to a _Crummey_ trust, a donor is not restricted in the type of property that may be contributed, and the donor, as trustee, may retain some control over the investments. In addition, the donor has the flexibility to determine what distributions from the trust will be appropriate without limiting them solely to education expenses. However, unlike a _Crummey_ trust, which may last beyond age 21, the beneficiary of a Section 2503(c) minor’s trust must be entitled to withdraw the trust property at the age of 21.

Therefore, a Section 2503(c) minor’s trust will create the same problems as an UTMA account regarding the age of distribution and as a _Crummey_ trust regarding administrative costs. A Section 529 plan solves both of these problems, assuming the investor intends that the funds be used for higher education.

Conclusion

For many investors, Section 529 plans will be the clear choice when saving for college expenses. However, there will be situations in which Section 529 plans do not achieve some or all of the donor’s goals. In situations where a donor wishes the assets to be used for elementary and secondary school expenses, a Coverdell Account may be an appropriate vehicle. In

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21 397 F.2d 82 (9th Cir. 1968).
Costs of College: The Basics of Financial Aid

By BONNIE LEE BEHM, M.S.
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While it would be wonderful if all families were able to save an amount sufficient to pay for the cost of a college education, the reality is that the cost of a college education is outstripping most families’ ability to save. Therefore, many people today are applying for financial assistance to pay for all or some of that coveted degree. Because most people do not understand the theory and process of financial assistance, this can be a daunting task. This article provides a brief overview of the basics of financial aid to assist in unraveling some of the mystery behind the application process.

TYPES OF FINANCIAL ASSISTANCE – NEED-BASED VERSUS MERIT-BASED AID

Need-Based Assistance

Need-based assistance is aid awarded to a student to help finance educational costs based on the student and parents’ need or financial circumstances. There are currently two methods used to determine a family’s need:

1. Federal Methodology is a formula determined by the US Congress that calculates the expected family contribution that the federal government uses to determine a student’s eligibility for federal financial assistance programs. States and institutions may also utilize this formula to determine a family’s ability to pay the cost of an education. States and institutions may also make adjustments to the formula as long as they are not using it to disburse federal dollars. Students use a form called the Free Application for Federal Student Aid (“FAFSA”) to apply for aid and to be considered for federal, state and perhaps institutional assistance.

2. Institutional Methodology is the formula developed by the College Scholarship Service to calculate the expected family contribution to determine eligibility for institutional or other private sources of aid. Schools can use the formula as it is prescribed or may make adjustments deemed necessary to administer their own financial assistance programs. Institutions cannot use Institutional Methodology to award federal funds. Students use the College Scholarship Service (“CSS”) Financial Aid PROFILE form to report their information and determine their Expected Family Contribution.

The main difference between Institutional Methodology and Federal Methodology is how a student’s and parents’ income and assets are treated in determining the family’s ability to pay. Additionally, Institutional Methodology offers the institution more financial and demographic information to use in the assessment of a family’s financial situation.

Merit-Based Assistance

Merit-based assistance is funds awarded to a student based on talents or other achievements deemed appropriate by the awarding entity. Merit-based money may be based on academic, dramatic, literary, artistic, athletic or other talents. No standard applications are used to apply for

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circumstances where the donor anticipates that all of the assets will be applied prior to the beneficiary’s age of majority or where the donor is not concerned about the beneficiary gaining control of the assets upon obtaining the age of majority, an UTMA account may suffice. Similarly, if the age of majority is not a concern but the donor has specific terms he or she wishes to set out for distributions, a Section 2503(c) minor’s trust may be the best vehicle. Finally, if a donor prefers that assets remain in trust beyond the beneficiary’s age of majority and intends the assets to be distributed for purposes other than education, a Crummey trust may be the appropriate option. In any event, donors today are fortunate to have both the number of options currently available and the flexibility to mix and match options. With a little planning, every donor should be able to tailor an education savings strategy that meets his or her own unique circumstances and goals.
Financial Aid, continued

merit based aid. Each school determines its own process for awarding these funds. Financial need may also be used as a factor in determining merit-based funds, but if so it is usually secondary to talent.

THREE TYPES OF AID

Typically, financial assistance is awarded in one of the three ways.

Grants/Scholarships

Grants, a generic term used to describe funds that do not have to be repaid, are usually offered based on the student and parents' financial need. The term scholarship is most often associated with funds that are awarded on the basis of academics or other talents and do not have to be repaid. The federal or state government, an academic institution, or any other private organization whose goal is to assist students in financing an education may award funds.

Loans

Loans are funds used to pay for a student's education that must be repaid. Loans can be based on a family's financial need or based on the family's interest in borrowing to fund a child's education. The lender can be the federal or state government, a private financial institution, an academic institution or a private organization.

Work Study

Work Study includes funds that a student earns while enrolled in an academic institution. Work Study or Student Employment may be based on a student's financial need or their interest in working on or off campus during the academic year. Earnings may be paid by the federal or state government, private employer or the academic institution or a combination of any of these.

SOURCES OF FINANCIAL AID

Four Major Sources of Financial Assistance

Since no single source of financial aid can normally provide sufficient funds to the student, the institution combines multiple sources of aid to offer the family the dollars they need to attend the institution. Schools look to four sources of aid to make up the financial aid package.

Federal Sources

Federal dollars are those funds provided by the federal government to assist families in paying for an education. The funds can be allocated directly to the student, to the school, or subsidized by the federal government to award to the student. They are distributed on the basis of specific federal legislation. These funds are primarily need based; however, they may have some merit based components. If the funds are awarded based on need, the school must use Federal Methodology to determine the Expected Family Contribution.

State Sources

State dollars are resources allocated either directly or indirectly to the student, or to the school to award to the student, distributed on the basis of specific state legislation. The funds may be need-based or merit-based. States may use Federal Methodology or their own formula for determining who is to receive the funds.

Institutional Aid

Institutional dollars are funds set aside by the institution to distribute to its students. Funds may be derived directly from revenues, endowments, private donors or alumni. Funds may be need-based or merit-based. Institutions may use Federal Methodology, Institutional Methodology or an institutionally designed formula to award institutional funds.

Private Sources

Private dollars represent those resources awarded by private organizations to assist students in funding their educations. The funds can be awarded directly to the student or academic institution and can be need-based or merit-based. Organizations may use any criteria they wish to award the funds to the student.

COMPLETING THE FINANCIAL AID FORMS

Whose Financial Information Is Required?

The basic premise of financial assistance is that the student's parents are primarily responsible for the educational expenses. Only after they can no longer afford to provide the funds necessary to pay for the education does need-based assistance come into play. Therefore, information from both the student and parent(s) is used to determine ability to pay. Students who meet certain criteria can be evaluated without their parental resources but there are specific criteria for determining "dependent" or "independent" status.

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Dependency

Dependent Students

Information on both the student and the custodial parent is required if the student is deemed dependent for federal financial aid purposes. Non-custodial parental information may also be requested if the school is using Institutional Methodology. The student is dependent for the 2002-2003 academic year if he or she meets all of the following criteria: The student was born after January 1, 1979; the student is not a graduate or professional student; the student is not married; the student is not an orphan or ward of the court; the student is not a veteran; and the student does not have dependents, other than a spouse, who receive more than half of their support from the student.

Independent Students

Information on only the student and spouse, if applicable, is required if the student is deemed independent for financial aid purposes. The student is independent for the 2002-2003 academic year if the definition of dependent above is not met.

What Information Is Required?

Since the financial aid officer or federal or state agency is trying to assess the student and parent(s) ability to pay for the education, the school or agency needs to have the appropriate financial information to make that assessment. The financial background of the applicant is collected on one, or both forms, depending on whether the Federal Methodology or Institutional Methodology is used.

If the student is being considered for aid using Federal Methodology, the student needs to complete the Free Application for Federal Student Aid and any other form the institution feels is necessary to make an accurate assessment of the family's ability to pay.

The following information is collected on the FAFSA:

Student Information – Name, Social Security Number, year in college, housing status, enrollment plans, citizenship status, marital status, and student/spouse income and assets for the base year (for the 2002/2003 academic year, the base year is the income from the 2001 U.S. Income Tax Return).

Parental Information - The custodial parent's income and assets for the base year (for the 2002/2003 academic year the base year is the income from the parent’s 2001 U.S. Income Tax Return), household size, number in college, and age of older parent.

Additionally, a school can ask for whatever other financial and household information it feels is appropriate to make an assessment of the family's ability to pay.

Reporting Income

When applying for financial assistance there are specific items that are used to determine the financial strength of the family unit. When completing the forms the family is asked to report all income whether it is taxable or not. Examples of income that are included are: wages, salaries, tips, interest income, dividends, and other taxable income such as alimony received, business and farm income, capital gains, pensions, annuities, rents, unemployment compensation, Social Security, and Railroad Retirement benefits.

Additionally, income such
Financial Aid, continued

as child support, payments to tax-deferred or sheltered pension and
savings plans, deductible IRA or
Keogh Payments, tax exempt interest
income, foreign income exclusion,
welfare benefits, untaxed Social
Security, untaxed portions of
pensions, credit for federal tax on
special fuels, housing, food and other
living allowances, Veteran’s non-
educational benefits, Worker’s
compensation, and cash or money
paid on the student or parents’ behalf
are also considered in the assessment.

Reporting Assets

Since income alone does not
determine the financial strength of a
family unit, the formula also considers assets held by the student
and parent. An asset, for financial aid
purposes, is defined as property that
is owned by the family and has an
exchange value. There are typically
three types of assets in addition to
cash, savings, and checking accounts:
investments, businesses and
investment farms. Investments
include real estate, trust funds, mutual
funds, money-market funds, stocks,
bonds, commodities and precious
metals.

For Federal Methodology
purposes the law exempts the family’s
principal place of residence and the
family farm from consideration for
federal aid purposes. However,
institutions using Institutional
Methodology usually consider the
family home and farm as assets in
determining a student’s ability to pay.

Students and parents are
requested to report the net worth of
an investment or net worth of a
business or farm.

Since trusts also provide a
basis for financial strength, the
formula requires that the value of
trusts be reported. For this purpose,
funds in which the student, spouse, or
parent has an interest should be
reported as that person’s asset on the
application. As a general rule the
applicant must report the trust as an
asset even if the beneficiary’s access
to the trust is restricted. If the settlor
of a trust has voluntarily placed
restrictions on the use of the trust, then
the student should report the present
value of the trust as an asset. If a trust
has been restricted by court order,
however, the student should not report
it as an asset. An example of such a
restricted trust is one set up by court
order to pay for future surgery for the
victim of an accident.

The way in which the trust
must be reported varies according to
whether the student (or dependent
student’s parent) receives or will
receive the income, the trust principal
or both. In the case of divorce or
separation, where the trust is owned
jointly and ownership is not being
contested, the property and the debt are
equally divided between the owners
for reporting purposes, unless the
terms of the trust specify some other
method of division.

If a student, spouse or parent
receives only the income from the
trust, any income received in the base
year must be reported as income. Even
if the income accumulates in the trust
and is not paid out during the year, the
person who will receive the income
must report an asset value for the
income payable in the future. The trust
officer can usually calculate the
present value of the income the person
will receive while the trust exists. This
value represents the amount a third
person would be willing to pay to receive the income that the student (or
parent) will receive from the trust in
the future.

The student, spouse, or
parent who will receive only the trust
principal must report the present
value of the right to the trust principal
as an asset.

If a student, spouse, or
parent receives both the income and
the principal from the trust, the
student should report the present
value of both income and principal,
as described in the discussion of
principal only. If the trust provides
that the income accumulates until it
ends, the beneficiary should report as
an asset the present value of the funds
(bboth income and principal) that the
beneficiary expects to receive when
the trust ends.

Should the student, spouse
or parent be named as one of several
beneficiaries in a so-called
discretionary sprinkle trust the
answer is less clear. The applicant
should contact the school for
assistance in addressing this situation
on the application for financial
assistance.

Educational savings plans
are also taken into account in
determining a family’s ability to pay.
Depending on which plan the family
has will determine how the funds will
be used in the determination of
financial aid.

Qualified State Tuition Plans

Prepaid Tuition Plans

These plans allow units of
tuition to be bought before the student
attends college. Distributions from
a prepaid tuition plan are applied to
the beneficiary’s higher education
expenses and are included as part of
the financial aid package. This is
accomplished by either reducing the
student’s cost of attendance by the
amount of the distribution, or by

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including the amount of the distribution as a resource and estimated financial assistance. For the FAFSA, the investment value of prepaid tuition plans is not reported as an asset of either the holder or the beneficiary.

State Sponsored College Savings Plans

These plans allow a benefactor to deposit money into an account that will be used for the beneficiary’s college expenses. The buyer does not prepurchase tuition credits as with a prepaid tuition plan. Rather, this type of plan is essentially a special savings account.

The value of a college savings plan should be treated as an asset of the owner and not the beneficiary, because the owner can change the beneficiary at any time.

One Final Note

While all schools must adhere to federal or state regulations when awarding federal or state dollars, each institution can use its own criteria when awarding institutional dollars. If you are trying to determine your own or a client’s financial situation as it relates to financial assistance, it is highly recommended that the family first talk to the college or university to see what it considers in its analysis. Because each school has its own deadlines, forms, formulas and methods for awarding aid it is important that the family not make broad assumptions.

For additional information on financial assistance, you may want to begin your search with some of these websites. Additionally, the review of each college and university’s site for specific policies and procedures pertaining to financial assistance is highly recommended.

Websites
www.nasfaa.org – website of the National Association of Student Financial Aid Administrators
www.savingforcollege.com – an Internet guide to 529 Plans
www.finaid.org – a general site on financial assistance with excellent links to a variety of related aid matters
www.ifap.ed.gov – the Student Financial Aid Information site for Financial Aid Professionals sponsored by the US Department of Education

Reference

Herron Joins Orphans’ Court Bench

Former Philadelphia Trial Division Administrative Judge John W. Herron has been transferred, at his request, to the Orphans’ Court Division from commerce court, a program he spearheaded and developed.

Herron has been a trial division judge since 1987. He was appointed by Gov. Robert Casey and elected later the same year. On July 9, 2002, he was appointed to the Orphans’ Court Division by President Judge Frederica Massiah-Jackson.

Herron is a graduate of Duke University (1966) and Dickinson School of Law (1969), and a former Deputy District Attorney in Philadelphia. He has also been an Adjunct Professor of Trial Advocacy at The Beasley School of Law of Temple University and a guest lecturer and panelist at Pennsylvania Bar Institute CLE programs.

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United States v. Craft: Federal Tax Lien Attaches to Entireties Property, Eliminates Protection Afforded by Entireties Ownership in Pennsylvania

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

In United States v. Craft, No. 00-1831 (April 17, 2002) the Supreme Court held that each spouse’s interests in entireties property constitutes “property” or “rights to property” to which a federal tax lien may attach. The result in Craft was to allow attachment of a federal tax lien for one spouse’s tax liability to the entireties property of a Michigan taxpayer, which (like Pennsylvania) prior to Craft had put entireties property beyond the reach of a spouse’s separate creditors, including the Internal Revenue Service. The Supreme Court, refusing to be “struck blind” by a state’s legal fictions, eliminated a perceived abuse detrimental to the collection of federal taxes by looking at the actual substance of the interests rather than the state’s labels. The Craft Court determined that each spouse had many other kinds of substantive rights under Michigan law in addition to survivorship, allowed attachment of the lien, and identified the need to value the rights being attached. But it remanded to the Sixth Circuit to determine this value. Craft stands for the proposition that the IRS can utilize entireties property to satisfy the federal tax debt of one spouse, reversing well-settled law in Pennsylvania. Internal Revenue Service v. Gaster, 42 F.3d 787, 791 (3d Cir.1994)(despite propriety of levy, Pennsylvania law prohibits IRS from using funds from account held as tenants by the entireties to satisfy tax liability of one spouse); Stop 35 v. Haines, 374 Pa. Super. 604 (1988)(creditor cannot reach entireties property during lifetime of both spouses); Raffaele v. Granger, 196 F.2d 620, 622 (1952)(account held as tenants by the entireties under Pennsylvania law renders ineffective the Service’s attempt to deal separately with or dispose of the interest of one spouse in derogation of the other spouse’s ownership of the entire property). Craft clearly furthers a trend toward national uniformity in connection with the speedy collection of federal taxes by subjugating state law fictions to federal tax law.

Craft resulted from an appeal of a case that went to the Court of Appeals for the Sixth Circuit twice before reaching the Supreme Court. In Craft v. United States, 140 F.3d 638 (6th Cir. 1998)(hereinafter “Craft I”), a husband failed to pay federal income tax liabilities assessed against him. A federal tax lien attached to all of his property and property rights under §6321 of the Code, which is the general rule of attachment. The rule provides that the unpaid amount of tax (after the IRS issues a notice and demand and the taxpayer fails to pay), including interest, penalties, and costs “shall be a lien in favor of the United States upon all property and rights to property, whether real or personal belonging to the taxpayer.”

After notice of the lien was filed (and in connection with their divorce), Don and Sandra Craft jointly executed a quitclaim deed purporting to transfer Don’s interest in a piece of real property in Michigan that they had owned as tenants by the entirety, to Sandra. In Craft II, the Internal Revenue Service agreed to release the lien and allow the wife to sell the property, with half of the net proceeds to be held in escrow pending determination of the Government’s interest in the property. The husband died during the pendency of these various proceedings, and the wife brought an action to quiet title to the escrowed half of the proceeds. The District Court held that the federal tax lien attached to the husband’s interest in the tenancy by the entirety at the moment of transfer to the wife, and that the transfer to the buyers was invalid as a fraud on creditors, 65 F. Supp. 2d 651, 657-659 (W.D. Mich. 1999). When both parties appealed, a majority of the Sixth Circuit panel held that no lien attached because the husband had no separate interest, 140 F.3d at 643, or severable future interest, 140 F.3d at 644, in the entireties property under Michigan law, and remanded the case to the District Court on the issue of the fraudulent transfer. 140 F.3d at 644. Don Craft’s action of paying the mortgage while insolvent, effectuated a type of fraudulent conveyance under Michigan law because these payments had placed non-exempt funds beyond the reach of a creditor (Internal Revenue Service) thus “enhancing” the value of the entireties property by the amount of these payments, 233 F.3d at 370-371. Nevertheless, both the District Court and Sixth Circuit concluded that since the federal tax lien could not attach to the subject property under Michigan law, then paying the

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mortgage on it could not constitute a fraudulent conveyance attempting to evade the IRS. 65 F. Supp. 2d at 657-659. This result was described by the Supreme Court as "somewhat anomalous" in light of its holding and it indicated that in future cases this question would undoubtedly be answered differently. Slip Opinion at 14-15.

The Supreme Court's analysis in Craft was consistent with the two-step analysis it had described in Drye v. United States, 120 S. Ct. 474, 481, 528 U.S. 49, 58 (1999). Initially it determined what state-defined rights the taxpayer had in the property the Government sought to attach. Then it applied federal law to determine whether such state-defined rights qualify as "property or rights to property" under §6321. See 120 S. Ct. at 481, 528 U.S. at 58. The Craft Court found that Michigan law gives an individual spouse, among other rights, the right to use the entities property, the right to exclude others from it, the right of survivorship, the right to become a tenant in common with equal shares upon divorce, the right to sell the property with the other spouse's consent and to receive half the proceeds from such a sale, the right to encumber the property with the consent of the other spouse, and the right to block the other spouse from selling or encumbering the property unilaterally. The Craft Court did not differentiate between real property and personal property owned by the entities.

The Craft Court determined that the rights granted to a spouse under Michigan law qualify as "property" or "rights to property" under §6321 because the broad statutory language authorizing the tax lien "reveals on its face that Congress meant to reach every interest in property that a taxpayer might have." Slip Opinion at 8, (citing United States v. National Bank of Commerce, 472 U.S. 713, 719-720). The Court reasoned that a Michigan spouse's substantial degree of control over the property was sufficient to justify attaching a federal tax lien to it, (citing Drye v. United States, 528 U.S. 49 (1999)), and that a spouse's unilateral ability to alienate the property was not required for the attachment of a federal tax lien. (citing United States v. Rodgers, 461 U.S. 677 (1983))(joint account attached for tax owned by one joint owner)), the purpose of which statute was to assure the collection of taxes (citing Glass City Bank v. United States, 326 U.S. 265, 267 (1945)), Slip Opinion at 8.

The Court further reasoned that excluding such property would "exempt a rather large amount of what is commonly thought of as property," and if "the entities property would belong to no one for the purposes of Section 6321," it would be an absurd result - and would allow "spouses to shield their property from federal taxation by classifying it as entities property, thus facilitating abuse of the federal tax system." Slip Opinion at 10-11. According to the Court, no legislative history evidenced any intent by Congress that entities property be exempted from the attachment of federal tax liens, including the broad language actually used by Congress. Slip Opinion at 13-14.

Pennsylvania is one of the majority of states with entities ownership which, like Michigan, considered entities property insulated from the attachment of federal tax liens. Internal Revenue Service v. Gaster, supra. In Pennsylvania, the law is well-established that a tenancy by the entities is a form of co-ownership of real or personal property by husband and wife, with its essential characteristic being that "each spouse is seized per tout et non per my, e.g. of the whole or the entirety and not of a share, moiety or divisible part." Fazekas v. Fazekas, 737 A.2d 1262, 1264 (Pa. Super. 1999)(citing In re Gallagher's Estate, 352 Pa. 476, 43 A.2d 132, 133 (1945) and Biehl v. Martin, 84 A. 953 (Pa. 1912)). In Pennsylvania, this form of ownership is easy to create and difficult to sever. A conveyance of real or personal property to a husband and wife, without more, vests in them an estate by the entities and where a husband transfers his property to his wife without consideration, the law presumes that a gift to the wife was intended. Brenner v. Sukenik, 410 Pa.324, 189 A.2d 246, 249 (1963). The severance, destruction or termination of an entities estate may not be achieved unilaterally except by death, but only through a couple's joint acts, such as divorce, or a joint conveyance or mutual agreement, either express or implied. Estate of Maljovec, 602 A.2d 1317, 1320 (Pa. Super. 1991). Prior to Craft, property owned by tenants by the entirety was not subject to the debts of either spouse. United States v. Green, 201 F.3d 251 (3d Cir. 2000) (citing Stauffer v. Stauffer, 465 Pa. 558, 576 (1976)). Also, where property or an account is placed in the names of husband and wife, and the creation of an estate by the entities presumed, it was not hindered by the fact that only one of the spouses contributed the funds to purchase the property. In re Estate of Cambest, 756 A.2d 45 (Pa. Super. 2000)(attorney-in-fact authorized by only one of spouses cannot sever entities ownership); Constitution Bank v. Olson, 620 A.2d 1146, 1149 (Pa. Super. 1993)(deposit in names of husband and wife while married, creates assumption of entities ownership unless rebutted by clear and convincing evidence); Raiken v. Mellon, 399 Pa. Super. 192 (1990)(pre-nuptial agreement did not prevent creation of ent-
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tieties ownership in subsequently acquired real estate and bonds). An estate by the entirety dies with the owner, who has no testamentary power of disposition over the property, the survivor receiving absolute title to the whole by operation of law. *In re Holmes Estate*, 200 A. 2d 745 (Pa. 1964) (securities); *In re Williams' Estate*, 349 Pa. 568, 37 A.2d 584 (1944).

In states which, prior to *Craft*, followed the minority rule, such as Massachusetts, the federal tax lien arising out of one spouse's separate tax liability attached to that taxpayer-spouse's interest in the property, subject to the non-taxpayer-spouse's right of survivorship, *Geiselman v. United States*, 961 F.2d 1 (1st Cir.1992) (husband has distinguishable and separate interests from wife in tenancy by the entirety under Massachusetts law). The IRS typically waited to see if any forms of termination occurred, such as divorce (which would generally cause the property to be owned as tenants in common) or death (which would result either in the IRS holding a lien attached to the property or the surviving spouse owning the property free and clear of the lien). Although the IRS could commence a judicial proceeding to sell the property and obtain the value of the taxpayer-spouse's interest, it generally waited for a termination to occur, rather than forcing a sale. In New Jersey, where state law also allowed attachment of entities property prior to the *Craft* decision, what the IRS obtained was the chance that the non-debtor spouse would die before the debtor spouse. *United States v. Avila*, 88 F.3d 229 (3d. Cir. 1996) (federal tax lien attaches to taxpayer-spouse's life estate and right of survivorship in the subject entities property and if taxpayer-spouse predeceases non-taxpayer spouse, lien is extinguished) (citing *Freda v. Commercial Trust Co.*, 118 N.J. 36 (1990) and *King v. Greene*, 30 N.J. 395, 412, 153 A.2d 49 (1959)). The IRS's understanding generally was that it became a tenant in common with the non-debtor spouse for the joint lives of the husband and wife. Slip Opinion at 11, n.9 (Thomas, Dissent) (citing IRS Litigation Bulletin No. 407 (Aug. 1994)). The *Craft* decision means that the IRS need not wait until the death of a spouse, but may value the lien upon attachment and foreclose upon it. Slip Opinion at 14.

Although it is also well-settled in Pennsylvania that the conversion through divorce of a tenancy by the entirety to a tenancy in common, especially in equitable distribution, does not enhance the lien of a secured creditor, *Fidelity Bank v. Carroll*, 416 Pa. Super. 9, 610 A.2d 481 (1992); accord, *Newman v. Chase*, 70 N.J. 254, 265, 359 A.2d 474 (1976), this has changed with *Craft* in connection with federal tax liens. The IRS now has the option of presently enforcing its lien, while other creditors do not have similar rights under existing Pennsylvania law. Before *Craft*, the non-debtor spouse's right of survivorship, like the restriction on a purchaser's right to partition the property, constrained the value of the interest subject to the lien. *Freda v. Commercial Trust Co.*, *supra*; *United States v. Avila*, *supra*. However this value is determined, *Craft* means that the IRS can collect presently on its liens in Pennsylvania.

*Craft* furthers a trend toward national uniformity in regard to the federal tax law as well as a trend initiated in *United States v. National Bank of Commerce*, 472 U.S. 713 (1985), facilitating the collection of federal taxes (IRS can levy on the joint accounts of a delinquent taxpayer even though state law did not allow ordinary creditors to do so). See also, *Drye v. United States*, *supra*; *United States v. Rodgers*, 461 U.S. 677 (1983) (state law exemption applicable to spouse's homestead interest does not prevent attachment of federal tax lien); *United States v. Mitchell*, 403 U.S. 190 (1971) (state law allowing wife to renounce her community property rights and obligations ineffective for federal tax purposes); *United States v. Heffron*, 158 F.2d 657 (9th Cir. 1947); *Barsev v. United States*, 5 F.3d 1414 (11th Cir. 1993) (state exemption not valid once refund is offset by IRS to student loan balance owed by taxpayer); *Cort v. United States*, 816 F. Supp. 574 (N.D. Cal. 1992) (state law exemption applicable to wife's state retirement account does not prevent levy by IRS for husband's back taxes); *United States v. Riggs National Bank*, 636 F. Supp. 172 (D.D.C. 1986) (spendthrift trust established under state law may prevent creditors' liens from attaching to trust corpus but is not effective against federal tax lien).

A further example of this trend toward national uniformity, which may also be impacted by *Craft*, was reflected in the final regulations issued on December 30, 1997 under I.R.C. §2518, T.D. 8744 (effective December 31, 1997 for disclaimers thereafter), which allows both a joint tenant with the right of survivorship and a joint owner that owns real estate by the entirety to disclaim a 50% survivorship interest within 9 months of the date of death of the first joint owner to die, regardless of (1) whether the tenancy is unilaterally severable, (2) state law, and (3) the portion of the property attributable to contribution furnished by the disclaimant. The examples thereunder clarify that entities property may be disclaimed, whether real or personal property. While entities continued on page 15
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Craft has dramatically changed the traditional asset protection afforded by entities ownership. Slip Opinion at 1 (Scalia dissent). One reason for this is that Craft implies that payment of any creditor other than the IRS is potentially a fraudulent conveyance. Both the District Court and Sixth Circuit had concluded that, since the federal tax lien could not attach to the subject property under Michigan law, paying the mortgage on it could not constitute a fraudulent conveyance attempting to evade the IRS. 65 F. Supp. 2d at 657-659. However, the Supreme Court described this result as "somewhat anomalous" in light of its holding, and indicated that in future cases this question would undoubtedly be answered differently. Slip Opinion at 14-15. Under the Pennsylvania Uniform Fraudulent Conveyances Act, 12 Pa. Cons. Stat. Ann. §5104 (2002), actual fraud constitutes a rebuttable presumption where a spouse transfers property to the other spouse for inadequate consideration, regardless of solvency. In re Blatstein, 192 F.3d 88, 97-98 (3d Cir. 1999). Taken together, it is predictable that all payments and transfers other than to the IRS subsequent to assessment will be scrutinized and may constitute fraudulent conveyances. Although some of the traditional protection eliminated by Craft may have been replaced by the "innocent spouse" provisions enacted in §6015 of the Internal Revenue Code, such provisions would only offer protection in connection with federal taxes, and have no impact on state law creditors.

In Craft, the Court implied that partnerships may be more desirable vehicles for holding property than entities ownership to the extent that asset protection is a goal. The Craft court affirmed the value of placing assets in partnership form for asset protection when it compared the attachment of a lien to a partner's interest in a partnership with the attachment of a lien to entities property. The Court confirmed that the lien does not attach to the entire partnership nor to its underlying assets but merely to the offending partner's interest in the partnership, upon which the Service may foreclose but may not compel a sale. Slip Opinion at 11-12. Three justices separately dissented in Craft, partially resulting from a disagreement over whether interests in property held by a partnership and in a tenancy by the entities ought to be treated similarly. The majority confirmed the disparity but explained it thus: "This disparity in treatment between the two forms of ownership, however, arises from our decision in United States v. Rodgers, 461 U.S. 677 (1983) (holding that the Government may foreclose on property even where the co-owners lack the right of unilateral alienation), and not our holding today," Slip Opinion at 12.

Entitlements ownership is easier to create than a partnership, since entitlements ownership is presumed in the law and thus created automatically; a married couple must opt out if they wish another form of ownership. A partnership requires an agreement. Thus, as long as creditors other than the IRS cannot attach such interests, entities ownership will be utilized by most spouses. However, following Craft, other creditors are expected to challenge and may successfully erode the protection offered by entities ownership. A partnership may provide greater protection because, for example, under the Pennsylvania Uniform Partnership Act, 15 Pa. Cons. Stat. Ann. §321(g)(4), a partner is required to obtain express authority from co-partners to execute a warrant of attorney to confess judgment against the partnership and/or his co-partners. Resolution Trust Corporation v. Forest Grove, Inc., 33 F.3d 284 (3d Cir. 1994). While it will be impractical for most married couples to enter into partnership solution instead of entities ownership, there will be some instances where this alternative should now be seriously considered.

As a result of Craft, entitlements interests will have to be valued. It is uncertain how much impact a body of law that is developed for purposes of federal tax lien attachment will have on the valuation of entitlements interests for other purposes, such as in equitable distribution or estate planning. The Craft Court suggested that the value of the attached interest is not equal to 50% of the value of the entire property, and remanded to the Sixth Circuit to determine the proper valuation of the attached entitlements interest. Slip Opinion at 14. As one commentator has already suggested:

[The value of the tenancy owned by either spouse may be subject to significant discounting related to the limited rights possessed by either tenant. By analogy, in the context of gift and estate...]

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taxes, significant discounts have been allowed for fractional interests related to such factors as lack of marketability, lack of control and other similar factors, which are similar to the attributes of an individual who owns property as a tenant by the entirety.

Mark L. Silow, “Extending Creditor’s Reach: United States v. Craft Allows Federal Tax Lien on Entireties,” THE LEGAL INTELLIGENCER (Philadelphia) vol. P3137 (May 14, 2002) p. 5. In our neighboring state, New Jersey, the value of such interests in entireties property has been described as “minimal, speculative, and their valuation so difficult and contentious, as to make such lien attachments impractical of pursuit in most instances.” Freda v. Commercial Trust Co., 118 N.J. at 38 (citing King v. Greene, 30 N.J. at 413–415, 153 A., 2d 49 (dissent)).

Under the Multiple Party Account Act, 20 Pa.C.S.A. §§6301-6306, an entireties account “belongs during the lifetime of all parties, to the parties in proportion to the net contributions by each to the sum on deposit, unless there is clear and convincing evidence of a different intent.” Id. at §6306(a); Wilhelm v. Wilhelm, 657 A.2d 34, 37 (Pa. Super. 1995). While the right of survivorship is not addressed by this statute, the consent of a non-contributing spouse to withdraw from an entireties account appears to be required during lifetime in Pennsylvania. In re Cambest Estate, supra. This may be a consideration in valuing the attachable amount in such an account in Pennsylvania, because at the time of attachment the amount contributed by the offending spouse is all that is “owned” by him. This may also be a consideration in executing on the lien, because what the offending spouse contributed during lifetime may be very different from what he “owns” as a surviving spouse. Query whether the methodology for determining the amount disclaimed by a spouse has any relationship to the methodology for valuing an entireties account attached by the federal tax lien. Because regulations issued by the IRS under §2518 do not address all tenancies created prior to January 1, 1998, the amount subject to disclaimer may be uncertain. Kenneth J. Levin, “Legal Basis for Advanced Planning Strategies Under Federal Tax Law and Pennsylvania Law,” Paper presented to the Tax Committee of the Probate and Trust Section of the Philadelphia Bar Association, April 2, 2002. Similarly, the amounts contributed by the offending spouse and the other spouse to the entireties interest being attached may be a consideration in valuing the interest being attached, even though a gift is generally presumed between spouses for creating an entireties account.

Craft, clearly a departure from prior law and policy, will dramatically impact creditors’ rights, including federal tax liens, in the Commonwealth. While it protects the fisc and achieves national uniformity, it is expected to create much disruption at the state level. Federal courts, including the Bankruptcy Court, are controlled by Craft, but state law creditors will try to extend their reach as well, and the traditional protections afforded by entireties ownership are more likely than not to become eroded in Pennsylvania.

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:

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Considerations for Potential Contributors to Donor-Advised Funds

By DAVID G. SHAPIRO
DECHERT

In recent years, donor-advised funds ("Funds") have grown increasingly popular as charitable giving vehicles. Many people who might otherwise consider establishing private foundations are turning to donor-advised funds because the funds provide significant tax advantages and ease of administration, while still allowing donors to guide how the funds are used. This article discusses the various advantages and disadvantages of donor-advised funds and identifies factors to consider when choosing among donor-advised funds.

How does a donor-advised fund work?

A Fund, like a private foundation, is a tax-exempt organization under §501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"). A donor is entitled to claim an immediate tax deduction (subject to limits noted below) for contributions to a Fund, just as one is to a private foundation. What distinguishes it from a private foundation, however, is that it is a public charity described in section 170(b)(1)(A)(vi) of the Code. This is because the Fund is treated for tax purposes as a single entity,2 so a Fund with many donors will pass the "public support" test with ease.2 Because the Fund is a public charity, a donor may claim an income tax deduction of up to 50% of his or her adjusted gross income.3 This higher limit on the income tax deduction is an advantage over a private foundation, contributions to which are deductible only up to 30% of the donor's annual contribution base.

A Fund looks to the outside world very much like a collection of private foundations. Donors typically can attach a name to the assets they contribute to the Fund (each a "Sub-Fund"), such as "the John Smith Memorial Fund." When the Fund makes a contribution out of the Smith Sub-Fund, the grant recipient can be advised that the contribution had been made by the John Smith Memorial Fund. In addition, the Smith family can ask that the Fund make an anonymous contribution—something that it would be unable to do if it had been set up as a private foundation. (The contribution would be identified as coming from the Fund, but without identifying any specific donor.) In order to maintain their own 501(c)(3) status, Funds require that all contributions be made to organizations that themselves qualify as charitable organizations under §501(c)(3). Donors are not entitled to claim income tax deductions for any contributions made from their Sub-Funds, as they already have claimed their deductions on the earlier contributions to the Fund.

Most Funds provide more than one investment option for Sub-Funds, depending on the donors' investment goals. Typically, Funds offer a growth portfolio, intended to build up a Sub-Fund to create a sizeable "endowment" for future contributions; a conservative portfolio, intended to maintain the size of a Sub-Fund at low risk; and sometimes offer one or more intermediate investment portfolios.

Potential donors should bear in mind that they are guaranteed control of neither the investment of their Sub-Fund nor the distribution of the money in their Sub-Fund. A Fund generally will try to honor donors' requests, as that is how it will continue on page 18.

1 In the case of Funds sponsored by charitable organizations, the Fund may be segregated funds within the larger charitable organization.

2 This test is set forth in Treas. Reg. § 1.170A-9(e)(2) and (6)-(7): Excluding disqualified persons, more than one-third of the Fund's support normally must come from the general public. For this purpose, a donor's contribution may be counted up to 2% of the Fund's total support for the year; if the sum of donors’ contributions, so limited, exceed one-third of the Fund's total support, then the Fund qualifies as a public charity. Thus, a Fund receiving contributions from hundreds or thousands of donors is likely to meet the public support test unless one donation is so huge as to overwhelm the rest of the contributions. If that mammoth donation were a one-time occurrence, the Fund still might be able to demonstrate that it “normally” receives more than one-third of its support from the general public.

3 See I.R.C. § 170(b)(1)(A). Note, however, that the deduction is limited to 30% of adjusted gross income in the case of contributions of capital gain property, such as stocks or bonds. See I.R.C. § 170(b)(1)(C).
Donor-Advised Funds, continued

attract money. However, it is under no obligation to do so. In order for a donor to be able to deduct a charitable contribution to the Fund, the Fund must retain control over the funds once contributed, and the contribution must be subject to no condition or power.4

Who sponsors donor-advised funds?

Most Funds are organized with a charitable purpose, but Fund sponsors may benefit themselves through management fees, typically a percentage of the Fund's assets. Some Funds are organized by traditional investment managers, such as Fidelity, Vanguard, and Charles Schwab. Some, such as the Jewish Communal Fund, are organized by charitable organizations,5 and a portion of the management fees benefit the charitable organizations (after paying third-party investment managers). Still other charitable organizations, such as Haverford College, establish donor-advised funds that require that each Sub-Fund make certain minimum distributions to the sponsor organization each year.

Why contribute to a donor-advised fund?

As noted above, for income tax purposes, contributions to a Fund are preferable to contributions to a private foundation. They are treated as contributions to a public charity, and therefore are less restricted than contributions to a private foundation.6

In addition, there are practical reasons to consider contributing assets to a Fund. The Fund handles all tax and other filings, taking such administrative burdens off the donor. The administrative costs also may be lower, as the Fund will benefit from the economies of scale associated with preparing a single tax return for a very large pool of assets, rather than individual returns for multiple foundations.

In addition, many Funds will allow a donor to build up assets within a Sub-Fund before making any distributions, while a private foundation must distribute 5% of its assets annually. As noted above, because a Fund is treated as a single entity, a donor effectively can rely on other donors' Sub-Fund distributions to reduce the distribution burdens on its own Sub-Fund.

With regard to control over donations, Fund sponsors typically provide donors with significant authority over the Fund assets. While Funds cannot give donors the right to direct how contributions are made from the Fund, donors can expect that if they designate acceptable beneficiaries, Funds will respect their wishes. A Fund that does not do so will lose future contributions, thereby reducing its sponsor's income. Although generally sponsors do not technically control Funds, they typically have enough influence to ensure that Funds continue to distribute funds in accordance with donors' wishes.

Some Funds organized by charitable organizations may require annual distributions from a Sub-Fund to the charitable organization sponsor. These organizations offer something of a hybrid between a donor-advised fund and a straight contribution to the sponsor. Because these Funds often offer favorable fees (or no fees at all), a donor who plans to make significant contributions to a charitable organization may wish to investigate whether it has a donor-advised fund program that can be used to pool contributions to that organization and any other organizations that the donor wishes to benefit.

What should a prospective donor consider when evaluating donor-advised funds?

There are many issues that a prospective donor should consider when evaluating a Fund. These considerations fall into two classes: flexibility and fees. In addition, a donor may wish to consider whether the Fund itself benefits a certain charity that the donor favors.

Funds, for their own ease of administration, may limit the number of distributions a donor may request in a year. In addition, each Fund provides a relatively limited range of investment alternatives and may restrict a donor's ability to request a reallocation of investments once made. A donor may also wish to consider the investment performance of the various portfolios that a Fund offers.

Funds also provide varying degrees of flexibility as to who can

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recommend distributions from the Fund. Some Funds permit only a single individual to make recommendations concerning distributions; others allow a donor to designate several individuals, a committee, or even an entity to recommend distributions from the Fund. In addition, Funds may permit a donor to designate one or more successors to recommend distributions in the event of the donor’s death or incapacity. Those successors may then be able to designate their own successors, creating consistent management like a private foundation.

Fees vary considerably by Fund. Typically they are computed based on a percentage of the assets in a Sub-Fund, much like a mutual fund. Some Funds organized by charitable organizations do not separately impose fees beyond those assessed by their investment advisors.

For administrative convenience, Funds require distributions to be at least a minimum amount, often $250 to $500. Many Funds require no annual distribution from each Sub-Fund, but Funds typically provide that in the event that the five-year average of total distributions from the Fund has not aggregated five percent of the Fund’s average total assets for that period, some or all Sub-Funds must make distributions sufficient to bring the Fund’s total distributions up to the minimum required level.7

As noted above, Funds organized by charitable organizations may require a minimum annual distribution to that organization. The Haverford Donor Advised Fund, for instance, requires that at least 50% of the annual investment income of a Sub-Fund be distributed to Haverford College.

7 This minimum distribution requirement is not statutory, but Funds establish this distribution approach (similar to the private foundation minimum distribution) as standard practice to ensure that their ruling applications are noncontroversial.

Tuesday, October 1, 2002
Staying Out of Trouble -- Avoiding State and IRS Disciplinary Proceedings.

Faculty: Solomon Fisher, Esquire
G. Bradley Rainer, Esquire
Barbara S. Rosenberg, Esquire

Location: PBI/PBEC – Wanamaker Building

This course will provide 2 hours of ethics CLE credit.

March 4, 2003
Planning for People with Disabilities -- An Update
Faculty to be announced.
## Comparison of several donor-advised funds

<table>
<thead>
<tr>
<th></th>
<th>Fidelity</th>
<th>Vanguard</th>
<th>National Philanthropic Trust (Pitcairn)</th>
<th>Haverford College</th>
<th>Jewish Communal Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Minimum initial grant</strong></td>
<td>$10,000</td>
<td>$25,000</td>
<td>$50,000</td>
<td>$100,000</td>
<td>$10,000</td>
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<tr>
<td><strong>Minimum additional grant</strong></td>
<td>$1,000</td>
<td>$5,000</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td><strong>Minimum for each distribution out</strong></td>
<td>$250</td>
<td>$500</td>
<td>$250</td>
<td></td>
<td>$250</td>
</tr>
<tr>
<td><strong>Minimum required balance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$20,000 (annual fee charged if balance too low)</td>
</tr>
<tr>
<td><strong>Minimum total annual distribution</strong></td>
<td>If Fidelity fails to meet the 5% test, it may require distributions out of any Sub-Fund that has not met the 5% test, and if no distributions are made will transfer an amount (up to the 5%) to the general fund for discretionary grantmaking. Also, if account is dormant for 7 years and the donor does not then recommend distributions, entire balance will revert to general fund.</td>
<td>Distributions may be required to meet the 5% test, and if no distributions are made will transfer an amount (up to the 5%) to the general fund for discretionary grantmaking.</td>
<td>Distributions may be required to meet 5% test (and will be made automatically). Donor may establish a rule to govern such distributions. If no distribution recommendations are received over a 3-year period, the funds may revert to the general fund for discretionary grantmaking.</td>
<td>Distributions must be sufficient to satisfy 5% test. At least half of all distributions must be made to Haverford College.</td>
<td>Distributions may be required to satisfy 5% test.</td>
</tr>
<tr>
<td><strong>Permitted advisors</strong></td>
<td>May designate other individuals or combination of self and others</td>
<td>May designate up to 2 individuals</td>
<td></td>
<td>May designate up to 2 individuals</td>
<td></td>
</tr>
<tr>
<td><strong>Permissible distributees</strong></td>
<td>described in 501(c)(3) and 509(a)(1)</td>
<td>described in 501(c)(3) and 509(a)</td>
<td>described in 501(c)(3)</td>
<td>described in 501(c)(3)</td>
<td></td>
</tr>
</tbody>
</table>

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

Question: May we lawyers represent co-trustees jointly?

Normally, the representation of all of the co-trustees of a trust does not pose a problem. That is what the trustees generally expect and it certainly makes the representation less expensive. If the lawyer foresees no likely tests of his or her duties of independent judgment and loyalty, he or she may certainly proceed with the joint representation of the co-trustees. There are some cautions, however, that are identical to those cautions that we face whenever we represent related parties or partners or shareholders in business transactions.

Conflicts among co-trustees usually arise in four areas: First, because we may have a longer or more rewarding relationship with one of the co-trustees, perhaps the surviving spouse who is a co-trustee with a corporate fiduciary, we may favor that co-trustee and bend to his or her will to the detriment of the other co-trustee(s). This can be an insidious problem that implicates Rule 1.7(b), which prohibits our representing the other co-trustee(s) whenever our doing so may be materially limited by our responsibilities to one of the co-trustees or whenever we are compromised in some manner by our own self-interests.

Conflicts can also arise when the co-trustees debate general investment philosophy and investment decisions, particularly when a co-trustee is a beneficiary. Pennsylvania’s new Uniform Principal and Income Act may help reduce the more acrimonious debates over investment philosophy. That Act permits the conversion to a total return trust or allows the power to adjust which can unshackle the investment decisions from the personal interests of the income beneficiary and the remaindermen.

Third, the co-trustees may have significant differences of opinion about exercising their distribution discretion. Finally, the size and allocation of co-trustees’ commissions is a potential area of conflict. When an individual co-trustee is a beneficiary he or she often sees either the size of the commission or the allocation of the commission between principal and income directly affecting his or her pocket.

When we see a conflict arising among co-trustees, one solution is to immediately advise the co-trustees that we cannot aid them in the resolution of the issue and suggest they work it out themselves. It is also permissible, pursuant to Rule 2.2, for the lawyer to serve as an “intermediary” in an effort to resolve the issue. While lawyers frequently take that approach, and think it practical, it can be dangerous. All of the co-trustees will want to know what their rights and recourse may be. In discharging the duty of independence and loyalty toward one co-trustee, the lawyer may take action or provide advice to the detriment of the other trustee(s) to whom the lawyer also owes a duty of independence and loyalty. Another solution is to have the disagreeing co-trustees seek special counsel to help resolve the issue while the initial lawyer continues as general counsel for the trust.

Some lawyers believe we can minimize or avoid these conflict problems by considering each of the co-trustees as a separate, rather than joint client. Other lawyers use the “family-as-an-entity” theory and cite Rule 1.13 for support. Neither theory resolves or avoids the conflict problem and, indeed, they can make the problem worse because the concepts can render the lawyer insensitive to existing or future conflicts between and among the co-trustees. A close reading of Rule 1.7(b) will show that neither theory can eliminate concerns about conflicts that can arise between and among co-trustees as set forth above.

Embarking upon a joint representation of the co-trustees is not improper so long as the lawyer is certain no conflicts exist at the outset and none can reasonably be foreseen. It is at the earliest stages the lawyer should be realistic about the conflict potential. At that point, the lawyer can generally choose which co-trustee he or she would like to represent and suggest that the remaining trustee(s) seek separate counsel. If the lawyer continues a joint representation of the co-trustees when a conflict exists, or after one arises, the Rules of Professional Conduct make it clear the lawyer may have to cease his or her representation of all of the co-trustees. In this situation, a lawyer cannot “change horses in midstream”.

Conflicts can arise very subtly and, because fiduciary lawyers are continued on page 21
Tax Update

By ROBERT J. WEINBERG
PEPPER HAMILTON, LLP

Estate Tax on the Uneducated Is Not a Violation of Equal Protection

In Estate of Karl C. Koester, et al. v. Comm., T.C. M. 2002-82, the estate argued that it was not liable for estate tax because the decedent had no more than an eighth grade education. The estate claimed that the complexity of modern tax laws deprives less educated individuals of the ability to understand how to use the available exemptions and exclusions to minimize or eliminate the tax. This, it argued, is a violation of the equal protection clause of the U.S. Constitution because the law treated less educated individuals differently than those with sufficient education to understand the law. Despite the decedent’s lack of education, he managed to accumulate an estate of over $1 million and had the intelligence to hire a lawyer to draft a will for him and his wife. The court ruled that it was constrained to considering the choices that were made under the will (which did not utilize the decedent’s unified credit) and did not have the power to consider events that could have, but did not, occur.

Tax Court Disallows Annual Exclusion for Gifts of LLC Interests

In Christine M. Hackl v. Commissioner, 118 T.C. No.14 (Feb. 27, 2002), the Tax Court ruled that gifts of membership interests in a limited liability company did not qualify for the present interest exclusion under §2503(b). In this case with far reaching implications, the LLC agreement vested exclusive management and broad discretion with the manager (in this case the donor/taxpayer), who was to perform his duties as he, in good faith, reasonably believed to be “in the best interests of the company, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.” The manager had the discretion to distribute to the members any cash available after payment of expenses, obligations and a working capital reserve. No member had the right to withdraw his or her capital account without the prior consent of the manager. Most importantly, no member could transfer any portion of his or her membership interest without the prior written consent of the manager, which could be given or withheld in the manager’s sole discretion.

The court noted that a present interest for purposes of §2503(b) exists only where a donee receives “noncontingent, independently exercisable rights of substantial economic benefit.” The court refused to draw a distinction between an indirect gift of property to a trust or other entity and an outright gift of equity in an operating company where the donee does not have the right presently to use, possess or enjoy the property. According to the court, it is not sufficient for a present interest that title has vested in the donee. The key inquiry is when substantial present economic enjoyment begins. In other words, the present interest test continued on page 22

Ethics Column, continued

so accustomed to dealing with families, the problems may not be noticed or they may arise in a fashion that forces the lawyer to drop the representation of not one, but all of the co-trustees. The challenge for lawyers representing parties jointly is to remain ever alert to potential conflict problems that could place them in a position of saying or doing something on behalf of one trustee that will be to the detriment of the other trustee(s). ☺

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

Probate and Trust Law Section Newsletter No. 104
Tax Update, continued

requires that as of the date of the gift the donee obtain “some presently reachable economic benefit.”

The court was not convinced by the argument of the taxpayer that the donees received a bundle of rights including the right to have the income and gains allocated to their accounts. Nor was the court persuaded by the pleas of the taxpayer that the restrictions in the LLC agreement are common in closely held enterprises. Instead, the court noted that there was no ability of a donee to unilaterally withdraw his or her capital and no ability to offer the units for sale without the consent of the manager. Hence, it could hardly be said that the economic benefit afforded by the membership interests was non-contingent. The court further noted that there was no present interest in the income of the company because of the manager’s discretion over distributions.

Some commentators have noted that the Hackl court failed to recognize that the restrictions on the members set forth in the agreement raised a question of value, not of whether the gift constituted a present interest. It appears, however, that the court focused on the question of the timing of economic benefit. A close reading of the case indicates that one key element was missing in the bundle of rights associated with the LLC - the ability of the donee to obtain the fair value (which would reflect the restrictions) at will. The restrictions on capital and income withdrawals alone would not appear to disqualify a gift of LLC or LP units so long as the donee was unilaterally able to realize the value of the units after accounting for those restrictions. The fatal flaw in the Hackl agreement was that transfer of the units to a third party required the manager’s prior consent. Even though LLC and partnership agreements commonly require such consent, practitioners should consider removing such a provision from their documents and permitting the members/partners to seek a buyer for their interests in the entity (albeit subject to a right of first refusal). However, total restraints on alienability appear to vitiate the economic benefit necessary to meet the present interest requirement.

IRS Attacks FLP Using the Step Transaction Doctrine

In TAM 200212006, the taxpayer created a limited partnership with her children and then funded the partnership with cash and marketable securities. The agreement permitted a partner to withdraw from the partnership on 60 days notice and receive a distribution equal to the fair market value of the partnership interest. The agreement also permitted a partner to transfer his or her units to a third party so long as the partner first offered to sell the units to the other partners. The IRS refused to permit a discount on the basis that the taxpayer made a gift of the underlying assets and not the partnership units. The IRS stated that it would reach the same result even if the taxpayer’s contributions were first allocated to her capital account, and then reallocated to the capital accounts of the other partners. According to the IRS, such a gift would involve a series of steps with no independent economic significance and could therefore be ignored. The initial allocation to the taxpayer’s account would be transitory in nature. The ruling signifies the importance of having the taxpayer first contribute property to the partnership and then transfer partnership units. However, the language of the ruling leaves one to one wonder whether the IRS intends to impose the step transaction doctrine even when the creation and funding of the partnership precedes the gift of the units.

Transfer of Property to Partnership Was Indirect Gift of Land

In Shepherd v. Comm., 89 AFTR 2d 2002-1251 (11th Cir. 2002), the appeals court ruled that the Tax Court, 115 T.C. 376 (2000), properly determined that a taxpayer’s transfer to his sons via a family partnership of fractional interests in leased land was an indirect gift of land, not partnership interests. The characterization as a gift of land was supported by the taxpayer’s own initial reporting position and the fact that the partnership did not exist under Alabama law until the day after the land transfer to the partnership. Moreover, the taxpayer’s alleged contrary intent was not sufficient grounds for a post-event re-characterization of the transaction. A similar result was reached by the IRS in TAM 200212006 as discussed above. In TAM 200212006, the IRS relied on the Tax Court decision in Shepherd.

Joint Revocable Trust Has Basis Step-Up Advantages

The IRS ruled in PLR 200210051 that a joint revocable trust created by a married couple and funded with individually owned and jointly owned assets would be included in its entirety in the estate of the first spouse to die. The ruling request described a trust in which the income was payable on a current basis to the couple and in which they could direct distributions of principal to themselves. At the first death, the trustee is directed to fund a general power of appointment marital trust.

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that, after accounting for the unified credit would result in no estate tax, with the remaining funds passing into a credit shelter trust. Both the marital and credit shelter trusts provide the surviving spouse with all of the income. The trustee may make principal invasions from the credit shelter trust pursuant to an ascertainable standard.

Because of the power of the first to die to change the trust or direct invasions of principal to himself or herself, the trust will be entirely included in the first estate under §§2038 and 2041. By ruling that the entire trust is included in the estate of the first to die, without regard for contribution, the IRS is permitting a full step-up in basis which would not have occurred if the assets were owned separately. However, the ruling notes that in accordance with §1014(e) any property contributed by the survivor within one year of the first death will not receive the step-up. In addition, the ruling states that the survivor will make a completed gift of the survivor’s interest in the trust to the decedent upon the first death. This gift will qualify for the marital deduction. Moreover, because the first to die is considered the transferor of all the assets, distributions to third parties from the credit shelter trust during the survivor’s lifetime will not be considered gifts by the survivor, and the assets of the credit shelter trust will not be included in the survivor’s estate. The ruling is highly favorable and appears to make a joint trust an attractive vehicle to achieve a full step-up in basis at the first death on all of a couple’s assets.

Entire GRAT is Includable Under Section 2039

In TAM 200210009, the IRS ruled that the entire principal of a grantor retained annuity trust was includable in the estate of the grantor where the grantor died during the annuity term. The document provided that the annuity payments were to continue to the grantor’s estate. The remainderman argued that §2039 could not apply because he would not receive the property by reason of surviving the grantor as required by §2039. However, the IRS ruled that §2039 applied notwithstanding the period intervening between the grantor’s death and the payment of the principal at the end of the annuity term. The ruling further stated that the amount of principal necessary to generate the annuity remaining for the estate was includable under § 2036.

Mellinger Type Discount Is Not Applicable to Stock over which Decedent has a General Power

In Estate of Aldo H. Fontana v. Comm., 118 T.C. 16 (March 28, 2002), the Tax Court ruled that for purposes of valuation, an estate must aggregate a block of closely-held stock owned by the decedent with a block of the same stock owned by a marital trust over which he had a general testamentary power of appointment. The court distinguished the ruling in Estate of Mellinger v. Comm., 112 T.C. 26 (1999), which allowed an estate to value separately the block of stock owned outright by the decedent and the block owned by a QTIP trust of which he was the beneficiary. In the Fontana case, the decedent owned a 50% block outright and the marital trust owned a 44.1% block. The court ruled that a testamentary general power of appointment is equivalent to outright ownership and thus the blocks should be aggregated for purposes of determining the decedent’s control of the company. The court noted that the QTIP trust in Mellinger is treated under the Code as passing from the decedent even though the surviving spouse never controls the disposition of the property and cannot have it pass as part of his estate. This is not the case with a general power marital trust.

S Stock Valuation Case Affirmed By Sixth Circuit

The Sixth Circuit denied a rehearing en banc and affirmed the Tax Court decision in Walter L. Gross, Jr., et al. v. Comm. 2002 U.S. App. Lexis 24803. The Tax Court ruled that in valuing S corporation stock for gift tax purposes the expert was correct in not adjusting the earnings to account for the income tax that would be paid by the owner of the stock. The Tax Court ruled that adjusting the earnings to reflect such taxes was one method for determining the cash flow, but was not always appropriate.

IRS Refuses to Recognize State Court Reformation

In TAM 200222024, the IRS refused to recognize a state court reformation of a trust that was granted on the basis of a scrivener’s error. The decedent executed a will with a marital trust and executed a management trust and funded the management trust. The trust contained a limited power permitting the surviving spouse to appoint the property to the decedent’s descendants. The spouse disclaimed the power to appoint, and the descendants disclaimed any rights to receive assets that they had under the two trusts during the spouse’s lifetime. The state court then reformed the two trusts to correct mistakes that were fatal to the marital deduction. The IRS ruled that the disclaimers were valid as to the management trust but that the disqualifying language in the marital trust was not the result of a

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scrivener’s error, despite the state court’s ruling. It therefore refused to allow a marital deduction for those assets.

Unitrust Conversion Does Not Affect GST Grandfathering

In PLR 200217036 and PLR 200217037, the IRS ruled that a trust exempt from the generation-skipping tax because it was irrevocable prior to September 25, 1985 would not lose its grandfathered status as a result of a division into two separate trusts with one of the new trusts converted to a unitrust. The new trust will pay the beneficiary the greater of the net income or 4% of the trust’s value on a three year rolling average.

Estate Tax Deduction Limited to Post Death Settlement of Claim

In FSA 200217022, an estate sought an estate tax deduction in an amount equal to the claim made against the estate arising from the motor vehicle accident in which the decedent died. The family of the other driver, who was also killed, filed a claim against the executor of the decedent’s estate, which was denied by the estate. The estate then settled the claim for a lesser amount than that demanded by the plaintiffs. On the 706, the executor took a deduction for the amount of the claim made, not the lesser amount paid in settlement. The IRS ruled that post-death events limited the deduction to the amount of the settlement. It noted that there are two lines of cases, one holding that post-death events are not relevant in determining values for estate tax purposes, see Ihaca Trust v. Comm., 279 U.S. 151 (1929), and one holding that post-death events may be considered, see Jacobs v. Comm., 34 F.2d 233 (8th Cir. 1929). With respect to whether post-death events may be considered in determining the amount of a deduction under § 2053(a)(3), the ruling explained that “the Eleventh Circuit noted recently in Estate of O’Neal v. Commissioner, 258 F.3d 1265, 1271 (11th Cir. 2001), that this area of law is generally governed by ‘two distinct and irreconcilable lines of cases’ namely, the cases that follow Ihaca Trust, and the cases that follow Jacobs. The Commissioner’s published position is that post-death events are controlling in determining the amount that may be deducted as a claim against the estate whether or not the claim is contested or contingent.” The court also reviewed the Ninth Circuit (the governing jurisdiction) case of Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982), which did not take into account post-death events as to a lien that was ascertainable at death. The IRS noted that, in dicta, the Propstra court said that “[t]he law is clear that post-death events are relevant when computing the deduction to be taken for disputed and contingent claims.” Id. at 1253. Hence, the IRS ruling limited the deduction to the amount actually paid at settlement.

IRS Refuses to Allow Revocation of QTIP Election

In PLR 200219003, the executor of the estate of a wife elected QTIP treatment for 100% of the assets of a marital trust. Some time later, the husband died and the executor noted that the full unified credit of the wife was not used because of the complete QTIP election. The wife’s executor then requested relief under § 301.9100-1(c) of the Procedure and Administration Regulations (which permits the IRS to grant extensions to make tax elections if the taxpayer acted in good faith and the interests of the government are not prejudiced). In this case, the taxpayer did not seek to extend the time to make an election, but sought the opportunity to revoke a portion of the QTIP election so that the full unified credit of the wife could be used. The IRS noted that IRC § 2056(b)(7)(B)(v) renders the QTIP election irrevocable and ruled that it had no authority to permit a revocation of the election. It noted that Rev. Proc. 2001-38, 2001-24 I.R.B. 1335, provides relief from prior QTIP elections where the election was not necessary to reduce the estate to zero. However, the IRS claimed that “the revenue procedure does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero.”

Limited Partnership Units Included Under Section 2036(c)

In Estate of Harper v. Comm. T.C.M. 2002-121 (May 15, 2002), the decedent’s gross estate included under § 2036(a) family limited partnership interests that he gave to his children during his lifetime because the decedent operated the partnership in a fashion that disregarded the terms of the partnership agreement and because he retained the essential economic benefit of the partnership. The decedent’s son was the general partner and in control of the partnership affairs. The decedent had been diagnosed with terminal cancer at the time the partnership was funded. The court noted that there was no impermissible co-mingling of funds. Despite the partnership agreement’s requirement that all funds of the partnership were to be deposited in a separate bank account, no such account was opened until more than 3 months after the entity

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began its legal existence. Prior to that time, partnership income was deposited in the decedent’s revocable trust account. While the court acknowledged that the partnership did come into existence prior to the decedent’s death and that some change ensued in the formal relationship of those involved to the assets, it found that any practical effect during the decedent’s life was minimal. Rather, the partnership served primarily as an alternate vehicle through which decedent would provide for his children at his death. For example, decedent continued to be the principal economic beneficiary of the contributed property after the partnership’s creation. The check register indicated that partnership funds were distributed for the benefit of the children in the amounts of $5,800 and $8,700, respectively, while during the same time frame, partnership checks totaling $231,820 were remitted to the decedent’s revocable trust. Given this pattern, the court said that it could not conclude other than that the partnership arrangement did little to curtail the access of the decedent or his estate to the economic benefit of the contributed property.

In addition, the son’s technical control over management and distributions was ignored by the court. “Although there was testimony that the son reinvested proceeds of maturing bonds, and [he] presumably collected interest and dividends paid on securities held in the partnership’s name, these activities are more akin to passively administrating than to actively managing the contributed portfolio. From the documents in the record, it appears that the composition of the portfolio changed little prior to decedent’s death.” The court also noted that a significant percentage of the portfolio consisted of professionally managed bond funds. The court’s reasoning with respect to the limited duties and control of the general partner is somewhat strained, and it appears that the court gave significant weight to the fact that the decedent had been diagnosed with a terminal illness at the time of the transactions in question and it therefore viewed the partnership as a “deathbed” transaction.

the Bar’s attempt to formulate a new rule on multi-jurisdictional practice. This was a complex issue and Rob’s leadership was crucial.

Former Section chair Margaret Sager is working hard to revive the “5-county committee” acting as liaison with our fiduciary colleagues in the suburban counties. This is important to us all. As one county or the other adopts measures responsive to legitimate practice needs and technology advances, we want to encourage other counties nearby to do the same. It has been a challenge to revive this liaison committee, and we are grateful for Margaret’s continuing contributions to the Section’s good work. Thanks, Margaret!

Have a great summer everyone!

Report of the Chair, continued from page 1

AIDS Law Project of Pennsylvania

If you know of any other pro bono organizations that could use this program to publicize their need for legal assistance on probate and trust matters, please contact the chair of the Public Service Committee, Andrea Hyatt Callan (215-751-2275).

Have you signed up for the Section list serve yet? If you would like to (so you can receive informative emails and other helpful tidbits involving our practice area), go to our Section’s portion of the Philadelphia Bar Association web page www.philabar.org and click on Sections and select Probate & Trust Law from the drop down. You will also find some big improvements to the web page as we have posted 2 things of special interest: the Section newsletter (last 4 editions), and of particular interest, the Report of the Advisory Committee on Decedents’ Estate Laws of the Joint State Government Commission with the official comments on the new Principal and Income Act for your easy reference! Take a look now!

A recent meeting of the Taxation Committee, which always has a well-planned series of meetings, had over 30 lawyers in attendance. Andrea Lawrence deserves our support for the excellent job she’s doing chairing that important committee.

I want to thank Rob Friedman, too, for helping us deal thoughtfully with