REPORT OF THE CHAIR

BY AARON H. FOX, ESQUIRE | PENNSYLVANIA TRUST

As the Chair of our Section, I was invited to attend the Bar Leaders Retreat in Atlantic City last month. While there were many different topics discussed over the day and a half of panel sessions, one theme seemed to run through every discussion, and that theme can best be described as “change.” Judy Stein, who served as our Chair last year, wrote about this a few months back, and I thought I would expand on it in this report.

Despite its rich traditions formed over 200+ years, the Philadelphia Bar Association is not unlike any other professional organization. From time to time, the leaders of the organization must re-evaluate the mandate of the organization, and determine if it is still successfully achieving that mandate. While this is a difficult exercise, it’s vital to any organization if it wants to stay relevant in the community and continue to meet its core mission.

I cannot express how impressed I was to see so many people at the Retreat working together to explore new ideas (and improve upon old ones) to further the Association’s core mission of promoting justice, professional excellence, and respect for the rule of law. As we have all seen in our own workplace, inertia is an incredibly powerful force, and often things stay the same simply because it just takes too much time and effort to change them, even when everyone knows that change is needed. At the Retreat, Chancellor Alfano and the rest of the Bar Association staff encouraged all attendees to provide their honest feedback and give suggestions on how to improve all aspects of the way the Bar operates. This included ideas about increasing membership, engaging younger lawyers to determine how the Bar can assist with networking opportunities, and determining how to better publicize the recommendations of the Judicial Commission. The Chancellor also solicited the group’s opinion on a new program that will enable the Bar to be more visible in the modern 24-hour news cycle on pressing legal matters in the Philadelphia community. While the prospect of significant change can be a

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“IT IS REWARDING TO BE PART OF A TEAM THAT PRIDES ITSELF ON BUILDING STRONG PERSONAL RELATIONSHIPS.”

Aaron H. Fox, Esq.
Senior Vice President
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**ADVISING PROBATE AND TRUST CLIENTS WITH REAL ESTATE**

**BY SCOTT S. SMALL, SENIOR REGIONAL FIDUCIARY MANAGER AND SENIOR VICE PRESIDENT | WELLS FARGO PRIVATE BANK**

**AUTHOR’S NOTE:** This brief essay - except for its final section - does not consider residential real estate inhabited by a trust settlor or beneficiaries (including qualified personal residence trusts). The author also extends his grateful appreciation to his colleagues at Wells Fargo, Michael J. Carr and William Nimmo, for their assistance with this subject matter.

Why do some of your clients hold multiple parcels of real estate in their investment portfolio? For most individuals who invest in real estate, these assets represent a significant portion of their net worth. Many investors cite growth potential and the ability to create cash flow. Beyond the financial value, the real estate may symbolize the original source of family wealth, shared memories, or be a symbol of the hard work and sacrifices of an earlier generation.

It’s a fact: clients generally have an emotional attachment to their real estate. It might be something that has been passed down as part of their family legacy or is something they acquired many years earlier as the first tangible proof of their success. Therefore, they really like to talk about their properties, and they are very careful about who they’re willing to entrust with the management and strategic direction of their real estate holdings. In many cases, real estate is a significant portion of a client’s wealth — and the wealthier they are, the more real estate they typically own.

Advising clients with a real estate portfolio requires that these assets must be considered within the context of the overall portfolio (including fixed income, equities, and other alternative assets), family needs and financial objectives. Compared with other investments, advising clients with real estate usually requires a higher commitment of time, attention and experience.

In my experience, the client who is real estate-intensive falls within one of the following three profiles:

1. **Clients who are in transition**

   Personal situations often trigger the need to focus on the real estate held by a client. These personal situations typically are death, divorce, illness, or inheritance. For example, my organization recently had occasion to advise a family where the family matriarch recently had passed away and three siblings had inherited significant commercial real estate holdings throughout the Southeast. The siblings had large estate taxes to pay because of the inheritance — adding stress to their personal lives and their relationships with each other. Serving as advisor to this sort of client may include assisting in the sale of some of the assets to create the liquidity they

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**REPORT OF THE CHAIR, CONTINUED**

daunting concept to some, it can also be an opportunity to improve and evolve, and I’m confident that is the direction the Association is headed in.

A final word on change….As many of you know, the Bar will now be a direct provider of CLE programs for the membership. As a former member of the Education Committee, I would be remiss if I didn’t take this opportunity to get in a plug for the Section’s next Quarterly Meeting on March 3rd at the Loews Hotel. We have a terrific panel and I expect a great CLE program. I hope to see everyone there.
need to pay their taxes. Ranking the real estate assets within the portfolio into three categories (the “Ohs,” the “Oh mys,” and the “Oh my goshes”) will help the client to determine which properties to continue to hold (typically, the properties in the last category) and which properties to sell for the liquidity needs (typically, the properties in the first category).

2. Clients who are facing a problem

It may sound trite, but client problems may be opportunities in disguise. Perhaps it’s a debt-related issue, perhaps they want to sell some holdings, maybe they have cash flow needs, or perhaps they have partner and/or family matters that need to be resolved. These types of situations are often triggered by a real estate problem that needs to be fixed, but the client doesn’t know what action to take or which action might be most beneficial. For example, consider a family from Philadelphia — with commercial real estate in San Antonio, Texas — where one of the buildings is vacant. The clients may be unsure about the best strategies for the sale and/or lease of a property located halfway across the country. Their problem may provide you with the opportunity to demonstrate your excellence.

3. Clients who want to invest in real estate

You may encounter clients who are looking to invest in real estate for the first time or who want to add property to an existing portfolio. In either case, they’re looking for diversification and/or income, but they may not have the expertise, contacts, or resources to find the right opportunities. A strong advisor will help this family clarify their objectives and leverage outside resources that can help them meet their goals. For example, my organization was contacted last year by an attorney who had a client that was looking to expand her family’s real estate holdings in the Pacific Northwest. Through this attorney, we became involved in the acquisition of two office buildings in the Seattle area for this attorney’s clients. One of the buildings ended up being acquired via a Section 1031 like-kind exchange; the other transaction involved the leveraged acquisition of a building that was occupied by a large Fortune 500 technology company on a long-term lease. In both cases, the attorney enhanced his attorney-client relationship with the family.

What is real estate management?

In order to be the best advisor for your client who owns real estate, you need to possess at least a rudimentary understanding of what tasks, duties and responsibilities are involved in the management of real estate. Real estate management involves two separate and distinct areas: “asset management” and “property management.”

Asset Management

“Asset management” involves the financial aspects of ownership and treats the real estate as only one component of the family wealth. The real property should be evaluated in terms of growth, income, tax impact, estate planning, wealth transfer taxation and the individual’s desire to leave a legacy. Asset management ideally provides an unbiased, objective focus on the investment performance of the asset — such as value, income and growth, tax considerations, capital improvements, risk mitigation and how the asset fits within the client’s overall wealth plan.

Asset management typically encompasses the following tasks, duties and responsibilities:

• Developing and implementing strategies to help maximize growth, net income, and total return on investment.
ADVISING PROBATE AND TRUST CLIENTS WITH REAL ESTATE, CONTINUED

• Obtaining periodic valuations of the properties (e.g., every 2-3 years)
• Managing sales, acquisitions, and capital improvements
• Overseeing lease negotiations and tenant relations
• Analyzing potential risks and developing a plan to manage or reduce the occurrence of risk
• Collaborating with other legal, accounting and tax advisors in reviewing, analyzing and reporting financial metrics to the client
• Analyzing for, and capitalizing upon, alternative-use opportunities
• Identifying financing options, opportunities and benefits

Performance Assessment
• Identifying alternative uses for the subject property and exploring the available exit strategies
• Comparing the performance of the subject property to the market; forecasting and budgeting for future performance; and planning for cash flow needs
• Identifying which option is most advantageous: keeping existing properties, selling off a portion of the properties, making a like-kind exchange, or acquiring additional properties

Managing Debt and Credit
• Identifying potential leverage strategies for the client’s assets
• Determining solutions to de-leverage the client’s assets
• Managing loan applications and due diligence
• Keeping track of debt maturities and recourse obligations, covenants, and reporting requirements
• Arranging financing or refinancing

Risk Management
• Assessing risks from environmental concerns, potential litigation, or building code violations
• Reviewing for proper levels and types of insurance, responding to any losses, and filing appropriate claims
• Assessing and evaluating tenant creditworthiness

Transaction Coordination
• Identifying buyers and/or sellers
• Managing property sales, Section 1031 exchanges, leasebacks and partnership or LLC entity level sales
• Identifying capital sources and recommending solutions such as debt, equity, mezzanine or participating debt, and other advanced secondary financing structures
• Originating and executing lease and sale-lease transactions

Acquisition Assistance
• Helping the client clarify her or his investment and portfolio objectives
• Analyzing all acquisition opportunities with thorough
ADVISING PROBATE AND TRUST CLIENTS WITH REAL ESTATE, CONTINUED

market and financial underwriting

• Arranging financing
• Overseeing the closing process and managing the assets post-close

Property Management

In contrast, “property management” refers to the resources and skills typically needed to handle day-to-day operations on the subject property, such as income and expense accounting and reporting, repairs and maintenance, tenant relations, lease negotiation and rent collection. Property management tasks, duties and responsibilities typically involve the following:

• Collecting rents and keeping records
• Automating accounts receivable and accounts payable systems
• Collaborating with advisors to comply with applicable codes, zoning, and ordinances
• Managing and overseeing maintenance, repairs, and renovations
• Managing budgets and debt service

• Reviewing property taxes and assessments

Some clients are DIY when it comes to property management. Other clients may employ an outside manager as their agent for accomplishing these property management tasks to relieve the client from the day-to-day effort of managing their properties. Regardless of the approach, the property manager or managers focus on the following:

• Handling tenant relations, responding to inquiries, and managing service requests
• Managing financial accounts, receiving and processing rent payments, reviewing and paying expenses, reconciling operating expense charges, and managing reserves
• Performing periodic property inspections
• Monitoring and paying property taxes and requesting appeals as needed
• Managing collection actions and legal notifications
• Supervising other property management vendors (e.g., contractors and subcontractors) by:

- Overseeing operations
- Overseeing repairs and maintenance management
- Determining scope of work or services
- Obtaining and reviewing bids
- Assessing vendor licensing and insurance
- Executing and administering vendor contracts

Challenges

The four most common challenges you will face in advising clients with real estate are cash flow issues, lack of diversification, beneficiary-occupied properties and transition of duties and ownership.

Cash Flow

Even when things are going well, repair and maintenance bills may come due before rental income arrives or the sale of a property is closed. Expenses both predictable (taxes, insurance, association/condo fees) and unpredictable (storm damage, capital improvements) mean the client must proactively plan for these expenses and build adequate cash reserves. If advising the trustee of

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a trust that holds real estate, does the trust have enough liquid assets to support the property or should a portion of the financial burden be allocated to the beneficiaries?

**Lack of Diversification**

Having too much of the overall wealth tied-up in a long-term investment like real estate can subject the portfolio to unnecessary risk and adverse market conditions. The client also may be unable to capitalize on other investment opportunities during a buyer’s market due to lack of adequate liquidity.

**Beneficiary-Occupied Properties**

The challenges here are almost too numerous to list, but a few of the most common are proper maintenance, over-improvement of the property, hoarders in or on properties, liabilities such as slip-and-fall lawsuits or attractive nuisance lawsuits, and environmental contamination on or around the property.

**Transition of Duties and Ownership**

Inevitably and inexorably, the time will come when the client will want (or need) to hand off the day-to-day management of the real estate assets to the next generation or to key associates. Planning for a gradual transfer while the client is still active allows you to share your expertise, provide advice and monitor the skills of the successor. Bluntly stated, now is the time to plan for the future while your client controls the crafting and implementation of ownership and operation agreements.

**Real Estate Held in Trusts**

I would be remiss if I did not re-iterate some of the points made by my fellow professionals Lindsey Foster Johnson at Pitcairn Trust and the now-retired David Rowe from BNY Mellon during the March, 2013 Quarterly Meeting of our Section in their “Trusts: Drafting Well to Administer Well” presentation. The attorney faced with a client situation in which real estate is held in trust should always review the governing trust instrument for any specific provisions concerning the ownership, use, maintenance, sale or other disposition of real estate. Several useful administrative provisions exist for the prudent administration of real estate held in trusts. For example, you should make sure that powers related to environmental risk are included in trust agreements that are intended to hold commercial real estate. Those provisions should include allowing the trustee to inspect for compliance with environmental laws, to alleviate or remedy environmental damages, to expend trust property for such purposes, to protect the trustees and beneficiaries from liability, and to abandon and/or refuse to accept a subject property.

By way of further example, a provision that addresses the disposition of proceeds in the event of a sale of the trust-owned real estate can be a real blessing in a time of beneficiary angst and anxiety. Does the provision allow the sales proceeds to be used for the purchase of another property? Or, is the trustee required to reinvest the proceeds in another property for the beneficiary(ies)?

Finally, when reviewing trust agreements for provisions related to the administration and management of real estate within a trust, the attorney should consider the following issues/questions in the event the settlor or trust beneficiary are using/residing in the real estate:

- Who may reside in the property and for how long?
- What other rights does anyone have under the trust?
- Does the right of an income beneficiary to use or reside in the subject property represent part of her income?
- Should the beneficiary be charged rent?

**ADVISING PROBATE AND TRUST CLIENTS WITH REAL ESTATE, CONTINUED**

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ADVISING PROBATE AND TRUST CLIENTS WITH REAL ESTATE, CONTINUED

• If the trustee has elected to make use of the Pennsylvania Uniform Principal and Income Act provisions related to the power to adjust or the power to convert to a unitrust, should the value of the property be included in the calculation of the amount to be paid to the beneficiaries?

• How should taxes and insurance costs be allocated between principal and income, and who should pay those costs?

To learn more about this topic, come to the Probate Section Quarterly Meeting at 12:30 p.m. Thursday, March 3, at the Loew’s Hotel. See below for more information.

PROGRAM NOTE

Learn more about how best to deal with real property in trust and estate administration at the upcoming program titled

Probate Meets Real Estate: What You Don’t Know Can Hurt You

When: Thursday, March 3, 2016
12:30-2:30 p.m.

Where: Probate Section Quarterly Meeting
Loews Hotel, Washington Room,
1200 Market Street, Philadelphia, PA 19107
Two recent cases highlight the topic of personal goodwill as it may apply to business valuations for estate and gift tax purposes.

**Bross Trucking, Inc., T.C Memo 2014-107**

In *Bross Trucking*, the Service contended that Bross Trucking, Inc. distributed appreciated intangible assets (goodwill) to its sole shareholder, Chester Bross, who then transferred the intangibles to a newly formed entity owned by his sons. If the goodwill was distributed from the corporation, the corporation would recognize taxable income, and, since it had a zero basis, a gift tax would apply upon transfer to his children. In this case, the Tax Court found that the company had no entity goodwill at the time of the distribution; that Chester Bross’ personal goodwill constituted all of the company’s goodwill; and that Chester Bross had not transferred goodwill to the Company. Notably, Mr. Bross was not bound by an employment agreement or a non-compete agreement.

**Estate of Adell, T.C. Memo 2014-155**

In this case, the taxpayer contended that personal goodwill owned by the decedent’s son, Kevin Adell, was not a corporate asset. Kevin was not bound by a non-competition or other agreement, nor was he a shareholder in the company.

At issue was the adjustment to operating expenses to reflect an economic charge for use of Kevin’s personal goodwill. The taxpayer argued for a charge on the order of $8 to $12 million, which significantly reduced projected earnings and value, while the Service contended that a much lesser charge applied, based on what a hypothetical buyer would pay to retain Kevin’s services. In this instance, The Tax Court sided with the taxpayer and allowed a substantial economic charge, finding that the goodwill belonged to Kevin Adell.

* * *

As evidenced by these cases, personal goodwill can be distinguished from entity goodwill.

Entity goodwill is attached to a business enterprise. For tax purposes, entity goodwill may encompass customer lists, technology, trained and assembled work force, and trade/brand name, etc. It may also be related to repeat patronage attributable to entity-specific characteristics such as location.

Personal goodwill is attributable to a specific employee or employees.

If an entity enjoys higher profits as a direct result of an individual employee’s unique attributes or characteristics, personal goodwill may be demonstrated to be a valuable asset. Typically, personal goodwill is characterized by 1) relationships; 2) expertise or knowledge; 3) skills or talents or 4) personal reputation.

Courts have found that absent binding noncompetition agreements, where personal contacts and relationships are important to the business, personal goodwill can exist separate and apart from, or to the exclusion of, entity goodwill. Further, personal goodwill may be transferred to an employer through employment agreements or non-competition agreements. *Martin Ice Cream Co.*, 110 T.C. 189 (1998); *H&M Inc.* v. Commissioner, T.C. Memo. 2012-290.

To make the case, here are some questions to consider:

- Do noncompetition and employment agreements exist and, if they do, do they assure transfer of all, or just a part, of personal goodwill?
- Who really owns the customer relationships, know-how and/or reputation?
TAX UPDATE

BY MARGERY J. SCHNEIDER, ESQUIRE | ROSENN JENKINS & GREENWALD, LLP

FEDERAL ESTATE TAX

New Basis Rules

Surface Transportation and Veterans Health Care Choice Improvement Act of 2015

Certain provisions of this law amend IRC Section 1014(f) and add IRC Section 6035(a). IRC Section 1014(f) now provides that beneficiaries of estates must use the finally determined estate tax value of any assets they receive as the basis for income tax purposes. New IRC Section 6035(a) requires the executor of any estate subject to federal estate tax to report the finally determined estate tax values (as reported on Form 706) to the IRS and to the beneficiaries. However, property subject to the marital or charitable deduction is not reportable.

GOODWILL, CONTINUED

• Does the business have intangible attributes that can be disassociated from the key employee(s)?

• How does the key individual’s compensation play into the picture?

• What would things look like if the key individual departed and potentially entered into competition?

In the case of all Federal Estate Tax returns filed after July 31, 2015, under IRC Section 6035(a) the executor must furnish a statement identifying the basis of each item of property included in the decedent’s gross estate for federal estate tax purposes to the IRS and the beneficiaries no later than thirty days of the due date of the filing of the estate tax return, with the first return due as early as August 30, 2015. However, in Notice 2015-57 (August 21, 2015), the IRS postponed the due date to February 29, 2016 for each statement that would have been required to be provided on or before February 29, 2016 under IRC Section 6035; and in Notice 2016-19, further postponed the due date to March 31, 2016 for any statement that would have been required to be provided on or before March 31, 2016.

New IRS Form 8971 and Instructions (January 2016)

New IRS Form 8971 and instructions are now final. The purpose of the form is to establish the basis of assets received by each beneficiary. Executors of estates filing a federal estate tax return are required to file this form, which consists of a schedule identifying the estate tax value of assets to be received by each beneficiary. The form must be filed within thirty days of the filing of Form 706. If the value of the assets going to each beneficiary cannot be identified by that date, the form must report all potential assets that may go to each beneficiary. As the instructions provide:

All property acquired (or expected to be acquired) by a beneficiary must be listed on that beneficiary’s Schedule A. If the executor has not determined which beneficiary is to receive an item of property as of the due date of the Form 8971 and Schedule(s) A, the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary’s distribution on that beneficiary’s Schedule A.

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TAX UPDATE, CONTINUED

A separate Schedule A must be provided to any beneficiary receiving property from the estate.

Transcript Instead of Estate Tax Closing Letter


As a follow-up to its announcement that, for all estate tax returns filed on or after June 1, 2015, estate tax closing letters would not be automatically issued to the taxpayer and would be issued only upon the taxpayer’s request, the IRS indicated in December, 2015 that a taxpayer’s account transcript may be an acceptable substitute for the estate tax closing letter. The transcript must “reflect transactions including the acceptance of Form 706 and the completion of an examination.” The transcript can be obtained either online through the IRS’s Transcript Delivery Service or by fax or mail by filing Form 4506-T.

Family LLC

Estate of Barbara M. Purdue v. Commissioner, T.C. Memo. 2015-249; Nos. 12994-12, 29829-12

In an estate tax dispute, the Tax Court found that the decedent, who died in 2007, had legitimate nontax reasons for forming a family LLC in 2000, affirmed the valuation discounts associated with it, and determined that the assets in the LLC were therefore not includible in her estate.

The decedent and her spouse had transferred stock holdings and their interest in a building to a family LLC. The IRS argued that the transfer of property to the LLC was not a bona fide transfer for adequate consideration. The Court cited several actions taken by the family that proved that the LLC was formed for a nontax reason, which was to consolidate and manage the family’s considerable amount of investments. The Court considered the following factors significant in proving that a bona fide sale occurred:

- Decedent and her late husband were not financially dependent on distributions from the LLC. They retained assets outside of the LLC to pay for their living expenses.
- The LLC had its own bank account and personal assets were not commingled with those of the LLC.
- The formalities of the LLC were observed.
- The five children, in their capacity as trustees and beneficiaries, observed the formalities of a business in running the LLC, with written records and annual meetings to discuss and act on the financial condition of the LLC.
- The decedent and her husband transferred the property to the LLC.
- Both the decedent and her husband were in good health when they made the transfers to the LLC.

The Court also determined that annual gifts of the interests to the LLC and a trust benefiting the issue of the decedent and her spouse represented present interest gifts under IRC 2503(b), because the LLC assets were producing rental income and dividends and made annual distributions in accordance with the LLC’s operating agreement and applicable Washington state law.

Settlement with IRS

Billhartz v. Commissioner, 794 F.3d 794 (7th Cir. 2015)

The U.S. Court of Appeals for the Seventh Circuit affirmed a Tax Court ruling which let stand a settlement between an estate and the IRS. In the settlement, the IRS allowed a 52.5 percent deduction of the $14 million that the estate had claimed for payments to four children by the first marriage of the decedent. The payments were based on a provision in the

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property settlement agreement from the divorce requiring the decedent to leave half of his estate to these children. After the settlement, the children brought a suit in state court claiming that they were entitled to a larger portion of the estate and that they had been fraudulently induced to agree to the settlement. The estate argued that the settlement should be vacated because if the children prevailed in the litigation, the settlement would prevent the estate from claiming an estate tax refund for the additional amounts received by the children.

In upholding the settlement, the Tax Court reasoned that by agreeing to the settlement, the estate ran the risk that new information could be subsequently discovered that would be harmful to it.

**Gift Tax**

*Estate of Edward Redstone v. Commissioner.* 145 T.C. No. 11 (October 26, 2015)

The Tax Court ruled that taxable gifts were not made as a result of a settlement between family members because the settlement was made in the ordinary course of business and met all three of the requirements for adequate and full consideration in money or money’s worth, i.e. the transfer was bona fide, at arm’s length, and lacked donative intent.

The dispute originated in Edward Redstone’s father’s incorporation of a family holding company making Edward, his father, and brother Sumner equal shareholders even though each had contributed different amounts of capital. Edward left the family business in 1971 and demanded his shares. His father refused to hand over his shares, claiming that they were held in an “oral trust” for the benefit of Edward’s children. A settlement was reached the next year, in which Edward agreed to transfer one-third of his shares to trusts for his children. The IRS, which became aware of the transfer only as a result of litigation brought by Edward’s children in 2006, issued a notice of deficiency and assessed additional tax on the grounds that Edward’s transfer of the shares to trusts for his children had been a gift.

The Tax Court determined that the transfer mandated by the settlement was made in the ordinary course of business because both sides had legitimate positions regarding the ownership of the shares and the transfer to the children constituted the settlement of a bona fide dispute. There was no donative intent because Edward had to acknowledge the “oral trust” in order to receive the additional shares of stock.

The Tax Court reasoned that, although the children provided no consideration in exchange for the funding of their trusts, the proper question was not whether they provided consideration but whether the transferor (Edward) received consideration. The Court found that Edward received consideration from his father consisting of the settlement of the claims against him.

*Sumner Redstone v. Commissioner, TC Memo 2015-237* (December 9, 2015)

The Tax Court held that the IRS is not legally barred from assessing gift taxes for stock transfers Sumner Redstone made to a trust for his children in 1972 but for which he failed to file a gift tax return. The doctrine of laches, which had been argued by Mr. Redstone, did not apply here for several reasons: first, the United States is not subject to the defense of laches in enforcing its rights, and secondly, the IRS was not informed of the gift transfers until 2010, although it had become aware of the transfers much earlier (through inquiries in connection with its Watergate investigation). The Court also ruled against Redstone’s argument that the deficiency should be set aside because the IRS violated the “one examination” rule of IRC Section 7605(b), reasoning that the review it had conducted in the 1970’s did not give rise to an examination.
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NEW STATEWIDE ORPHANS’ COURT RULE 1.6 FOR MEDIATION AND PBA’S APPROVED MODEL LOCAL RULE FOR MEDIATION

BY NEIL E. HENDERSHOT, HON. JAY J. HOBERG, AND BERNICE J. KOPLIN | CO-CHAIRS, FIDUCIARY MEDIATION SUBCOMMITTEE, ALTERNATIVE DISPUTE RESOLUTION COMMITTEE, PENNSYLVANIA BAR ASSOCIATION

New Statewide Orphans’ Court Rules

On December 1, 2015, the Pennsylvania Supreme Court issued an Order approving amended and restated procedural Supreme Court Orphans’ Court Rules (“New Statewide OC Rules”), to be applicable statewide to all judicial districts in Orphans’ Court Division and in Orphans’ Court matters, effective nine months later, on September 1, 2016. The New Statewide OC Rules were published in the Pennsylvania Bulletin on December 19, 2015, along with an Amended Order.

That Order was accompanied by a Report issued by the Supreme Court’s Orphans’ Court Procedural Rules Committee (“Statewide OC Rules Committee”), which provided background and explanation.

The New Statewide Rules replace most current statewide Orphans’ Court Rules, which were initially adopted in November 1975, effective January 1, 1976. However, certain current statewide and local OC rules were retained relating to existing Chapter 14 (Guardianships), Chapter 15 (Adoptions), and Chapter 16 (Abortion Control Act Proceedings). More recently, the Statewide Supreme Court Rules Committee published a Notice of Proposed Rulemaking, which offers for public comment a third revised set of proposed statewide OC rules under a new Chapter XV (Adoptions), with comments due by March 16, 2016.

The statewide Orphans’ Court Rules revision project began in October, 2007, upon initiative of the Supreme Court and its Chief Justice, Ralph Cappy. After six years of work within the Statewide OC Rules Committee, a set of proposed replacement statewide OC rules was published for public comment on April 13, 2013 (“Proposed Statewide OC Rules”), after which many comments were received, before finalization into the adopted and published New Statewide Orphans Court Rules on December 1, 2015.

A second Order, also dated December 1, 2015, vacated certain existing local Orphans’ Court Rules (except those related to Chapters 14, 15, and 16), effective as of September 1, 2016. That second order acknowledged “the continued necessity of existing local orphans’ court rules as of September 1, 2016”, and so directed the President Judge of each judicial district to review existing local rules in light of the newly adopted Statewide OC Rules.

Mediation under Statewide Orphans’ Court Rules

The Proposed Statewide OC Rules had included, for the first time, a proposed new Rule 1.6 authorizing mediation in the Orphans’ Court in matters under its jurisdiction. It was noted that “Rule 1.6 has no counterpart in former Orphans’ Court Rules.” The prior Proposed Statewide OC Rules suggested a rule entitled “Mediation by Local Rule or Special Order” as follows: “The Court, by Local Rule or special order, may direct the parties to participate in private or court-sponsored mediation.”

A group within the Pennsylvania Bar Association was formed in early 2014, by the current co-chairs, formally known as the Fiduciaries and Orphans’ Court Subcommittee, of the Alternative Dispute Resolution Committee, of the Pennsylvania Bar Association (the “Subcommittee”) to study the Proposed Statewide OC Rule 1.6 that would authorize mediation, and also to suggest further local rules and procedures for deployment.

The Subcommittee offered comment for a revised title and provision for proposed OC Rule 1.6. Eventually, the Subcommittee’s suggested revision was accepted,
but with one significant change revealed upon adoption of New Statewide OC Rule 1.6.

Anticipating with hope an ultimate adoption of some revised form of Rule 1.6 to authorize mediation in Orphans’ Court matters, the Subcommittee then focused upon a workable local Orphans’ Court rule and a set of proposed forms that could be adopted as “not inconsistent” with anticipated Rule 1.6, to enable mediation statewide in Orphans’ Court matters.

The Subcommittee prepared a Model Local Rule 1.6 to enable mediation in judicial districts and also developed procedural forms for use. The co-chairs researched mediation in such matters nationwide, and presented authority for adoption in Pennsylvania. The Subcommittee also considered the distinctive nature of Orphans’ Court matters involving fiduciaries, beneficiaries, and persons under a legal disability, and the special role of the Orphans’ Court in protecting certain persons and supervising certain matters under its jurisdiction.

The result of that effort by the Subcommittee was approval of the Model OC Mediation Project Report by the PBA Board of Governors on November 19, 2014, and by the full PBA House of Delegates unanimously on November 21, 2014. The Report was presented by the PBA’s Alternative Dispute Resolution (ADR) Committee and co-sponsored both by the PBA Real Property Probate and Trust (RPPT) Law Section and by the PBA Elder Law Section.

In early 2015, the PBA-approved Model OC Mediation Project Report was informally presented to the Statewide OC Rules Committee. In this informal colloquy, the Subcommittee became comfortable that its proposals for a local rule governing mediation would pass the test of being “not inconsistent” with a statewide OC Rule 1.6, either in the original or in the suggested form. The final form of New Statewide OC Rule 1.6 supports this likelihood and expectation.

Final Form of Rule 1.6 for Mediation

The revised, final version of New Statewide OC Rule 1.6, is entitled “Mediation by Agreement, Local Rule, or Court Order.” It provides: “All parties having an interest in a matter may participate by written agreement, or the court by local rule or order in a particular matter may provide for the parties to participate, in private mediation or in court-supervised mediation.”

The single alteration from the Subcommittee’s prior suggestion for revision was subtle, but substantive and significant. The final rule’s term “court-supervised”, instead of the Subcommittee’s suggested term “court-annexed”, clearly requires current Orphans’ Court involvement. That change makes clear that an Orphans’ Court must be in a “supervising” role in resolution, by some means, of a matter in contention or requiring determination.

The term “court-supervised” is not defined. Indeed, the word “supervised” only appears in one place in the New Statewide OC Rules – in Rule 1.6. This may necessitate an addition to the Model Local Rule to reference the docketing of a matter in some manner.

That change does not preclude private mediation without reference to Rule 1.6 in matters that might, if unresolved, still be presented to an Orphans’ Court for resolution by virtue of its jurisdiction. However, a local rule regarding mediation would not apply to such matters until docketed. The effects of a mediation not “supervised” by an Orphans’ Court might be unpredictable and unenforceable as to an agreement voluntarily attained. Likewise, an Orphans’ Court might not be bound by an un-supervised mediation if a party attempts to assert confidentiality of mediation provided by statute under 42 Pa.C.S. § 949 (referenced in the “Explanatory Comment” to New Statewide OC Rule 1.6).

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Subcommittee’s Promotion of the OC Mediation Project

The Subcommittee will further revise its packet of a Model Local Rule and forms, consistent with the final language of New Statewide OC Rule 1.6. The revised packet will be made available on the Pennsylvania Bar Association’s website, due to PBA approval, ADR Subcommittee oversight, and RPPT Section support.

The Subcommittee now promotes adoption – whether before June 1, 2016, or sometime thereafter – of a local OC Rule 1.6 in many judicial districts. The basic model will enable voluntary mediation in Orphans’ Court matters without further extensive study or drafting. Of course, local courts can modify the proposed Local Model OC Rule 1.6 to align with current practices in court-supervised mediation, or to integrate appointments and monitoring into procedures applicable to masters or auditors. The Subcommittee also urges usage of the minimal and workable set of sample forms for use in connection with a local OC Rule 1.6.

While New OC Rule 1.6 authorizes mediation in matters supervised by the Orphans’ Court, in the future, there could be expansion of such mediation into matters not yet filed, if not resolved otherwise by disputing parties in interest. But for the coming year, the Subcommittee will focus upon mediation for dispute settlement in the Orphans’ Court and in court-supervised matters.

ADDENDA: RULES

New Statewide OC Rule 1.6 provides as follows:

Rule 1.6. Mediation by Agreement, Local Rule or Court Order

All parties having an interest in a matter may participate by written agreement, or the court by local rule or order in a particular matter may provide for the parties to participate, in private mediation or in court-supervised mediation.

Note: Rule 1.6 has no counterpart in former Orphans’ Court Rules.

Explanatory Comment: The confidentiality of mediation is provided by statute, see 42 Pa.C.S. § 5949.

The Subcommittee proposed a Model Local OC Rule 1.6 in the following form, subject to local judicial modification as deemed appropriate. This proposed model rule will be revised by the Subcommittee prior to formal posting to integrate its definitions with those in the New Statewide OC Rules:

MODEL LOCAL ORPHANS’ COURT RULE 1.6

All parties in interest in a matter may use mediation to resolve issues pending before the Court, and, upon either partial or complete resolution, may petition the Court to approve the agreement of all parties in interest as an order or decree of the Court.

A. The parties in interest may engage the services of a mediator, either prior to or after any party in interest has filed a Pleading before the Court, including an Account filed by a fiduciary for audit.
B. Upon the filing of a Pleading before the Court, including an Account filed by a fiduciary for audit, the Clerk shall provide the filing party with generic information regarding availability of mediation for the resolution of disputes prior to adjudication by the Court.

C. The filing party shall provide such information to other parties in interest. The information, which does not bind the Court, and which may be in the form of a standard brochure, should include:

1. A brief description of the mediation process;
2. The anticipated benefits of mediation for litigants and associated professionals; and
3. Contact information to initiate mediation.

D. All the parties in interest in a matter docketed before the Court may request to engage in mediation at any time during the pendency of the matter.

E. In such request for mediation, all parties in interest shall identify:

1. The proposed mediator and the proposed source of payment of fees and costs of the mediator;
2. Names and contact information of all parties in interest and any counsel who shall participate in the mediation;
3. Names and information regarding any parties in interest having diminished capacity or a legal disability, whose interests must be adequately protected; and
4. The scheduled date for the initial mediation conference.

F. All parties in interest shall execute an agreement for confidential mediation, which is not inconsistent with this local rule, and which shall remain confidential.

G. Mediation shall not delay the required filing of any Pleading or ordered return dates, or the scheduling of Court Hearings, unless specifically requested by joinder of the parties in interest and so ordered by the Court.

H. The Court will respect the confidentiality of the mediation process and of the mediator’s obligation of confidentiality.

I. Upon completion of mediation, all parties in interest shall sign a memorandum of principal terms, which either shall acknowledge that no resolution was reached, or shall embody the resolutions attained. This memorandum of principal terms shall clearly state partial resolutions or complete resolution attained. The memorandum of principal terms shall include a list of unresolved issues to be determined by the Court. Where appropriate, the principal terms could provide for future review in light of changed circumstances or a change in the operative facts. The memorandum of principal terms agreed upon, or the statement of no resolution, shall be filed with the Court.

J. In no event shall the terms agreed upon depart from or violate any provisions of applicable law, specifically including the Older Adults Protective Services Act, the Act of Dec. 18, 1996, P.L.1125, No.169 (35 P. S. §§ 10225.101 — 10225.5102), as may be amended.

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K. The parties in interest may request that the Court approve the final mediated agreement, which embodies the principal terms agreed upon in the memorandum referenced above. The Court may grant approval in an order or decree. Alternatively, the Court may recommend any changes that the Court deems appropriate for approval. The parties to the mediation may accept the Court’s recommendations, in which event the terms agreed upon, as modified, shall be approved, or the parties may decline to accept the Court’s recommendations, in which event the matter is deemed not to have resulted in an agreement.

Such a Model Local Rule could be adopted in this form, saving drafting time and effort by local rules committees. It has been vetted informally by the Statewide OC Rules Committee already, so that this form of a Model Local Rule and the Forms in its appendix will be “not inconsistent” with the New Statewide OC Rules.

Because Chapter 10 of the New Statewide OC Rules addresses Registers of Wills, new Statewide OC Rule 1.6 and this Model Local Rule 1.6 could also apply to proceedings before that office if the outcome would become binding as court-supervised, where mediation could be appropriate for dispute resolution.

The Subcommittee encourages adoption of the Model Local Rule and the forms in judicial districts, so that the goal of statewide simplicity and consistency will be achieved in mediation under New Statewide OC Rule 1.6.

JOIN A COMMITTEE

The Section’s Committees depend on the steady flow of people, energy and ideas. Join one!

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A recent decision from the Montgomery County Orphans’ Court clarified that a beneficiary of an irrevocable trust with a spendthrift provision who purports to irrevocably assign the beneficiary’s right to receive principal distributions from such trust may revoke his or her alleged irrevocable assignment at any time.

**Middleton Trust** involved a trust created in 1982 by John Middleton, Inc. (the “Trust”), of which Frances Middleton was the sole income beneficiary during her life. The Trust instrument included the following valid spendthrift provision:

All interests hereunder, whether principal or income, while undistributed and in the possession of the Trustees, and even though vested or distributable, shall not be subject to attachment, execution or sequestration for any debt, contract, obligation or liability of any beneficiary, and furthermore, shall not be subject to pledge, assignment, conveyance, or anticipation.

Frances Middleton died on September 24, 2013, and the Trust became distributable outright in equal shares to her three children, one of whom was Anna Nupson (“Ms. Nupson”). In 1998, Ms. Nupson had executed a document (the “Assignment”) that purported to assign all principal distributions from the Trust payable to Ms. Nupson to another trust, of which Ms. Nupson was the settlor and beneficiary during her lifetime.

Prior to the death of Frances Middleton, no principal distributions had been payable to Ms. Nupson. In September 2015, Ms. Nupson wrote a letter to the trustee of the Trust, in which she revoked the Assignment; in which she revoked the Assignment and requested distribution of her share. Thereafter, Ms. Nupson filed a Petition for Declaratory Relief, and a subsequent motion for summary judgment, regarding whether the Assignment was enforceable in light of the facts that the Trust contained a spendthrift provision and the Trust principal had not been distributed. Responses by the motion were filed by the trustee of another trust and the contingent remainder beneficiaries of the trust to which Ms. Nupson had purportedly assigned her interest in the Trust (collectively, the “Respondents”).

The Court granted summary judgment to Ms. Nupson based on its consideration of four undisputed facts relevant to the validity of the Assignment: (1) the Trust contained a valid spendthrift clause; (2) Ms. Nupson executed the Assignment; (3) Ms. Nupson revoked the Assignment; and (4) the Trust never distributed assets in accordance with the Assignment and had not yet distributed any assets to the remainder beneficiaries of the Trust.

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1 The Orphans’ Court Litigation and Dispute Resolution Committee will provide summaries of recent litigation cases in each quarterly newsletter.

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CASE SUMMARY, CONTINUED

The Court explained that a valid spendthrift provision in a trust restrains the voluntary or involuntary transfer of a beneficiary’s present and/or future interest in a trust. Id. at 4-5 (citing 20 Pa. C.S. §7742(a)). Additionally, “[a] valid spendthrift provision makes it impossible for a beneficiary to make a legally binding, irrevocable transfer” of the beneficiary’s interest “‘because an irrevocable assignment would be equivalent to a transfer of the beneficiary’s interest.’” Id. at 5 (quoting In re Keeler’s Estate, 3 A.2d 413, 417 (Pa. 1939)). The Court noted that while a trustee can honor a beneficiary’s assignment of his or her interest, such assignment can be revoked at any time. Essentially, an assignment of an interest in a spendthrift trust authorizes the trustee to exercise his, her or its discretion to honor the assignment, but until such discretion is exercised in accordance with the assignment, such “assignment must be considered a nullity and disregarded.” Id. at 5 (quoting In re Williams’ Estate, 72 Montg. 395 (O.C. Montg. 1956)). Therefore, the Court held that Ms. Nupson’s revocation of the Assignment rendered it a nullity.

The Court noted that if the trustee had distributed Trust assets in accordance with the Assignment prior to Ms. Nupson’s revocation of the Assignment, the trustee would have been protected from liability for complying with the Assignment. However, after the revocation, the trustee of the Trust was bound to disregard the Assignment and honor the spendthrift clause of the Trust. Id. at 7-8.

The Respondents failed to present any relevant, disputed facts in response to Ms. Nupson’s motion for summary judgment. Id. at 6. Instead, the Respondents asserted that discovery was required with respect to various other issues, but the Court determined that those issues were irrelevant to its determination of whether the Assignment could be revoked.

The Respondents claimed that they needed discovery regarding whether Ms. Nupson received consideration for the Assignment. However, the Court noted that the additional discovery would not affect the issue before the Court (a pure question of law) because no facts would alter the fact that the Trust contained a spendthrift provision, meaning any assignment of an interest in the Trust could not be irrevocable. Additionally, the Court noted that even if Ms. Nupson received consideration for the Assignment, Ms. Nupson might be personally liable to the individual or entity that provided such consideration, but it would not change the validity of the spendthrift provision of the Trust or the ability to revoke the Assignment. Id. at 7.

The Respondents also sought discovery regarding Ms. Nupson’s intent in assigning her interest to the other trust, but the Court stated that Ms. Nupson’s intent is immaterial; only the intent of the Trust’s settlor – the intent to include a valid spendthrift provision – is relevant. Id. at 8.

The Respondents further claimed that by the Assignment, Ms. Nupson partially released her interest in the Trust. The Court disagreed and explained that the Assignment could not be a release or disclaimer because the Assignment directs that Trust principal be distributed to another trust, whereas if Ms. Nupson had disclaimed or released her interest in the Trust, the Trust principal would pass in accordance with the Trust provisions and not pursuant to any direction by Ms. Nupson. Id. at 8.

The Respondents also claimed that Ms. Nupson did not revoke the Assignment within a reasonable time under Section 7746(a) of the PEF Code, which involves distributions that are not made within a reasonable time. The Court stated that Section 7746(a) is inapplicable to the case because it involves distributions by a trustee, and not actions by a beneficiary. The Court again noted that a beneficiary can revoke his or her assignment of an interest in spendthrift trust at any time regarding future distributions. Id. at 9.

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Finally, the Respondents invoked several equitable doctrines (laches, equitable estoppel, unclean hands and unjust enrichment) and claimed that such doctrines presented additional questions of fact that required discovery. However, in presenting such doctrines, the Respondents failed to present any facts that would affect the validity of the spendthrift provision in the Trust or the validity of the revocation. Specifically, the Respondents did not show any change in position, reliance or other prejudice based on the Assignment to support a challenge to the validity of the revocation of the Assignment. Id. at 10-12.

Accordingly, this case illustrates that any purported assignment by a beneficiary of the beneficiary’s interest in a trust with a valid spendthrift clause can be revoked at any time with respect to any future distributions (i.e., distributions made after the revocation), regardless if such assignment is claimed to be irrevocable. Trustees should be aware that revocation can occur at any time, as should any individual or entity on the receiving end of such an assignment.

The Court’s determination was an immediately appealable Orphans’ Court Order under Pa. R.A.P. 342. The matter is presently on appeal to the Superior Court. See Trust of John Middleton, Inc., Superior Court No. 3389 EDA 2015.

HAVE IDEAS OR TOPICS FOR AN ETHICS COLUMN?

Send your questions and ideas to:

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

75th Anniversary Gala
Saturday, February 20, 2016
6:00 – 10:00 p.m.
The Logan Hotel
One Logan Square, Philadelphia, PA

March Luncheon Program
Tuesday, March 15, 2016
11:45 a.m. - 1:45 p.m.
The Union League
140 S. Broad Street, Philadelphia, PA
Topic: “Defining Fiduciary Excellence: From Trust Law to ERISA”
Speaker: Paul J. Brahim, CFP®, AIFA®

Annual Meeting & Reception
Thursday, May 5, 2016
3:00 – 8:00 p.m.
The College of Physicians of Philadelphia
19 South 22nd Street, Philadelphia, PA
Topic: “End of Life Issues”

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