REPORT OF THE CHAIR

BY LAURA E. STEGOSSI, ESQUIRE / DIAMOND, POLSKY & BAUER

In a few short months, the one-year anniversary of the adoption of the new Pennsylvania Orphans’ Court Rules, and the corresponding Philadelphia County Local Rules, will be upon us. By many accounts, the transition to the new rules has been a smooth one.

With the advent of the new Orphans' Court Rules, it is obvious that the Philadelphia Estate Practitioners Handbook (“PEPH”) needs significant revision. I’m pleased to report that the Section’s wheels are now turning to bring the PEPH up-to-date.

Attorneys new to the Section may not be fully acquainted with the PEPH, so some background is in order. The PEPH is the comprehensive guide complete with forms and explanatory narratives for practice before the Philadelphia Register of Wills and the Philadelphia Orphans’ Court. The PEPH consists of three practice aids – the Register of Wills (the “Green Book”) and Practice and Procedure Before the Orphans’ Court Division of the Court of Common Pleas of Philadelphia County (the “Red Book”).

In 2002, these three practice aids were compiled into one go-to handbook and initially distributed in a thick loose-leaf binder. I still have a dog-eared and heavily notated hard copy of the PEPH in my office. But most practitioners consult the PEPH online at www.peph.com. Gene Gillin, along with Daphne Goldman and a myriad of other dedicated volunteers, launched the inaugural version of the PEPH online and in book form. Gene reports that the PEPH website still receives thousands of hits each month, despite the fact that it is not up-to-date! Clearly, practitioners are still consulting this popular practice tool on a regular basis, and we have a duty to bring its Chapters and forms current.

Thankfully, the Rules and Practice Committee, co-chaired by Erin the Register of Wills (the “Green Book”) and Practice and Procedure Before the Orphans’ Court Division of the Court of Common Pleas of Philadelphia County (the “Red Book”).

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A SHIFTING LANDSCAPE: THE IMPACT OF DIVORCE AND OTHER LITIGATION ON IRREVOCABLE TRUSTS

BY BARBARA E. LITTLE, ESQUIRE, AND JANENE B. REILLY, ESQUIRE | OBERMAYER REBMANN MAXWELL & HIPPEL LLP

What parent wants their hard-earned money getting distributed to a former daughter/son-in-law or a creditor of their child? In our estate planning practice, we have yet to meet such a parent. Thus, we often recommend our clients (parents or grandparents) establish and fund a trust for the benefit of their children (or future generations). One of the many benefits of establishing an irrevocable trust (in Pennsylvania or New Jersey) is that if properly managed the assets held in the trust are protected from creditors – inclusive of a divorcing spouse. Our ingenious family law colleagues have begun to erode this protection such that in some jurisdictions, an irrevocable trust with a spendthrift clause may become subject to equitable distribution or included in the calculation for alimony. This article examines several recent divorce court cases in which one of the divorcing parties was the beneficiary of an irrevocable trust. It concludes with some insight and recommendations for drafting and administering an irrevocable trust so that the trust assets do not become the property of the non-beneficiary former spouse.

Prior to examining these cases, it is important to lay the framework and explain the key principles of an irrevocable trust. A trust is traditionally established through a legal document (inter vivos (during life) or testamentary (created at death under a Will)) that empowers a trustee to manage and oversee assets for the benefit of an individual. For example, a

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REPORT OF THE CHAIR, CONTINUED

E. McQuiggan and Neal G. Wiley, has agreed to take on the herculean task of updating the PEPH. In the spirit of cooperation, which is a hallmark of our Section, other Committees have committed to working on the PEPH project. In particular, the Orphans’ Court Litigation Committee, chaired by Adam T. Gusdorff, and the Elder Law and Guardianship Committee, co-chaired by Linda M. Hee and Anastasia DePaz, have agreed to contribute to the update efforts. The Rules and Practice Committee has already formed some subcommittees to review the current version of the PEPH.

Many volunteers are needed to support the effort. Volunteers need not feel compelled to participate in every section of every Book. You can lend your expertise where your interest lies. Every little bit will help to get this formidable job done. If you are interested in participating, please contact one of the Chairs involved.

If contributing your time and talents to the Section in another way is more to your liking, then be sure to check out the other Committees the Section offers, such as the Education Committee (Amy C. Quigg, Chair), the Business Planning Committee (Dennis C. Reardon and Robert H. Louis, Co-Chairs), the Legislative Committee (Bradley D. Terebelo, Chair), the Publications Committee (Heike K. Sullivan, Chair), and the Tax Committee (Brian R. Gilboy and Robert M. Maxwell, Co-Chairs).

I’d like to take this opportunity to give special thanks to Heike and her Committee for consistently putting together a first-rate Newsletter and to the authors of such timely and high-quality articles. Your hard work is much appreciated!
settlor may create a trust during his/her lifetime that gives legal ownership of one’s house or another asset (e.g., brokerage account) to a trustee. The trustee has the legal responsibility to manage and oversee the trust asset for the benefit of the trust beneficiaries (e.g., settlor’s children). The terms of the trust establish how and when the trustee may grant the economic interests of the trust assets to the trust beneficiaries (e.g., use of the house or access to the income earned on the investments). Such economic interest may be discretionary (completely up to the trustee to determine) or mandatory (trustee must distribute).

This economic interest is often limited and protected by the inclusion of a spendthrift clause. A spendthrift clause restricts a beneficiary’s ability to transfer rights to future payments of income or principal to a third party. In effect, the clause prevents “spendthrift” beneficiaries from squandering an inheritance before they receive it and also protects a beneficiary’s inheritance from creditors, in some/most jurisdictions inclusive of a divorcing spouse. The trust is a separate legal entity from the trust beneficiaries and is a separate taxpayer.

It is for this reason that trust assets were traditionally protected during the division of property or calculation of alimony in a divorce proceeding. With this framework in mind, we now turn to the examination of the case law in a few jurisdictions, to review the attempted erosion of spendthrift provision protection.

**Massachusetts**

In *Pfannenstiehl v. Pfannenstiehl*, 88 Mass. App. Ct. 121 (2015), the lower court awarded the non-beneficiary wife sixty percent (60%) of the present value of the husband’s interest in a discretionary spendthrift trust. The trust in question was settled by the husband’s father after his son’s marriage. A sibling and the attorney were the trustees. There were more than eleven (11) current beneficiaries under a distribution scheme which allowed for distribution of “income and principal as the trustee, in its sole discretion, may deem advisable …, whether in equal or unequal shares, to provide for the comfortable support, health, maintenance, welfare and education” of the beneficiaries. Trustees distributed irregularly, unequally and in some years made no distributions. Notably, the trust instrument included a spendthrift clause. The lower court opined that the husband had a one-eleventh (1/11) interest in the trust and therefore, awarded the wife a portion of such interest.

On appeal, the decision was reversed. The court held that the interest was too speculative because it was nothing more than an expectancy and thus not assignable. For a trust to be included in the consideration of available assets or sources of income, the trust instrument must be examined to determine if the interest is fixed and enforceable or remote and speculative. Interest in a discretionary trust is traditionally considered too remote for inclusion.

The court distinguished the trust in *Pfannenstiehl* from the trust involved in *Comins v. Comins*, 33 Mass. App. Ct. 28 (1992), which was determined to be a fixed interest and available for consideration of calculation of alimony. The Comins trust had one beneficiary, who received all of the income and held a power of appointment over the trust upon her death. In contrast, the *Pfannenstiehl* trust had over eleven (11) beneficiaries and was to continue for future generations. Therefore, the trustees were required to consider the long-term needs of the trust. Further, the distributions were made unequally between beneficiaries and in some years some beneficiaries did not receive a distribution. The court opined that the inclusion of the spendthrift clause was only mildly influential and did not bar inclusion under other circumstances. The

*continued on page 5*
court did, however, hold that the lower court (on remand) might consider the expectancy as part of the opportunity of each spouse to acquire future assets and income.

Arizona

Duckett v. Enomoto, No. CV-14,01771-PHX-NVW, 2016 WL 1554979 (D. Ariz. 2016), is not a divorce case, however, it still provides useful insight in relation to trust provisions and creditor protection. In Duckett, the court held that the Internal Revenue Service could attach a lien to a beneficiary’s interest in a discretionary trust. The court opined that such attachment was dependent on (a) state law; (b) the rights of the beneficiary; and (c) the obligations of the trustee. If the trustee had complete discretion over distributions, the lien could not attach. Conversely, if the trust instrument required mandatory distributions, the lien could attach. However, the court noted that between these two extremes were hybrid discretionary trusts which required further review. The Enomoto Trust was held to be a hybrid discretionary trust.

The trust instrument stated that “the Trustee shall pay to Dennis Masaki Enomoto so much or all of the net income and principal of the trust as in the sole discretion of the Trustee as may be required for support in the beneficiary’s accustomed manner of living, for medical, dental, hospital, and nursing expenses, or for reasonable expenses of education, including study at college and graduate levels” (emphasis added). The Court acknowledged that the trustee was obligated to distribute under an ascertainable standard, but only in his or her “sole discretion.” Nonetheless, the Court held the lien attached because of the term “shall.” “Shall” is a mandatory direction which requires payment and thus, the discretion is limited to the amount to be paid. The Court also took into consideration that Dennis was the sole beneficiary.

Delaware

In IMO Daniel Kloiber Dynasty Trust u/a/d December 20, 2002, 2014 WL 3924309, the non-beneficiary spouse was apparently successful in receiving a portion of a Delaware Dynasty Trust. The factual background of the matter was that the beneficiary spouse’s father established the Trust for the benefit of his son (the husband), his son’s spouse (who was required to be married to and cohabitating with son) and the son’s descendants. During the divorce proceedings, the wife argued that the Trust was includable in their property settlement based on Garretson v. Garretson, 306 A.2d 737 (1973). Under Garretson, a Delaware Support Trust (providing for distributions for health, education, maintenance and support) was determined to be susceptible to division between divorcing spouses, since a spouse is not a creditor and therefore is not bound by the spendthrift provisions. In Kloiber it appears the wife prevailed in securing an interest in the Dynasty Trust because in an Order to Sever the Trust, dated August 16, 2016, there is an agreement to sever the Dynasty Trust and fund a separate trust for the benefit of the wife.

Pennsylvania

Pennsylvania has a long history of enforcing spendthrift provisions and protecting trust beneficiaries. The impact of divorce on trusts is examined in the following cases:

In Eny Trust, 202 A.2d 30 (Pa 1964), the settlor executed an irrevocable trust that was to pay one-half of the net income to his wife, and one-half to their foster daughter upon his death. The settlor and wife then divorced, and the settlor remarried soon after. When the settlor died, the question arose as to whether the one-half share of the trust income went to the settlor’s first wife, the wife at the time the trust was created, or to the second wife, the wife at the time of his death. The lower court held that the trust referred to the settlor’s time-of-death wife and not his time-of-deed wife, and

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awarded the one-half share of the trust income to the settlor’s second wife.

The Supreme Court of Pennsylvania reversed the decision of the trial court and held that the trust was to be construed to refer to the first wife. The court looked to the settlor’s intentions from the language of the trust, and stated that the word “wife” did not indicate whether the settlor meant a specific wife. Thus, the circumstances under which the word “wife” was used needed to be considered. At the time the trust agreement was executed, the settlor was happily married to his first wife, who was his only wife and the only person the settlor could have been thinking of when using the word “wife” in executing the trust. The court stated that it could not attribute to the settlor a “prescience of future events when he might acquire another and different wife.” Thus, the court held that the first wife had the right to the one-half share of income from the trust.

A similar result was found in the recent case of In re Irrevocable Trust Agreement of Klein, PICS Case No. 16-0355 (C.P. Monroe, Jan 7, 2016), in which the settlor and his wife purchased a $2.5 million life insurance policy and created an irrevocable trust and split-dollar agreement regarding the life insurance policy. The irrevocable trust was designed to benefit the wife and the children, and the beneficiary of the policy was the irrevocable trust. The wife was required to pay all the premiums of the policy and the settlor was the original donor.

When the settlor and his wife divorced, the question arose whether the wife should remain as a beneficiary and a co-trustee of the irrevocable trust. The court found that the irrevocable trust set forth the parties’ intentions at the time of execution and referred to the wife as the donor’s spouse. Further, the court stated that there was no language in the irrevocable trust addressing divorce or a requirement that the parties’ remain married. Like the court in Emy, the court looked to the settlor’s intentions from the language of the trust at the time of execution. The court stated that absent any language indicating that the terms of the trust only applied if the parties’ remained married, the plain meaning of the trust showed that the parties intended the trust to benefit the wife. Further, the wife continued to pay the premiums for the policy after the divorce. Thus, the court held that the wife remained a beneficiary and a co-trustee following the divorce, as the parties intended to continue the policy for the benefit of the wife and the children.

New Jersey

The seminal case in New Jersey involving an irrevocable trust and divorce is Tannen v. Tannen, 416 N.J. Super. 248, 3 A.3d 1229 (2010). The court held that an interest in a purely discretionary trust was not deemed an asset attributable to the beneficiary in a divorce proceeding.

During their marriage, the wife’s parents established an irrevocable trust for the benefit of the their daughter, the wife. The wife and her parents all served as the trustees. The trust assets included the family’s home, commercial property and liquid assets. The trustees regularly paid the real estate taxes and contributed to the housekeeper’s salary and other capital improvements for the real property. Trust assets were also used to pay for the private schooling of the children.

The trust instrument provided that distributions were to be made for “the beneficiary’s health, support, maintenance, education and general welfare,” and were to be made in the sole discretion of the trustees “in the beneficiary’s best interests, after taking into account the other financial resources available to the beneficiary[.]”

The trust further provided that “the beneficiary shall not be permitted, under any circumstances, to compel distributions of income

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continued on page 7
and/or principal prior to the time of final distribution” and the trust instrument included a spendthrift clause.

During the divorce proceedings, the trial court ruled that the wife had a fiduciary duty to seek income from the trust and imputed a monthly distribution of $4,000 attributed to the wife for the calculation of alimony. The Appellate Division reversed, holding that the trust assets were not attributable to the wife. Although one consideration was whether there was income available to either party through investment of any assets held by that party, it was opined that such income does not have to actually be available, so long as the party has the ability to access the income . . . it is inconsequential if the income is actually received. Here, based on the specific language of the trust, the income was determined not to be available or attributable to the wife.

Interestingly, the Appellate Division recited the fact the wife had contributed her residence to the Trust and that she could alienate her interest in the Trust with the consent of the trustees. However, the court ignored these facts in reaching its decision, because such contribution makes the trust at least partially self-settled, and thus, under New Jersey law, not protected from creditors.

Insights

These cases provide important insight into how we draft and administer trusts in a manner that maximizes the protections afforded. Of course, this must be balanced with the specific needs and desires of our clients. Accordingly, sometime maximum protection must give way to other planning goals. Drafting insights include:

• Use the word “may” as opposed to “shall.”

Trust administration insights include:

• Do not fund the trust with personal assets, but instead, all the assets should be attributable to a third-party donor.

• If the trust is purely discretionary do not create a systematic distribution scheme. Instead, have the distributions ebb and flow with the needs of the beneficiary.

• Refrain from distributions during a divorce or bankruptcy.
POWERS OF APPOINTMENT AND DEFERRING DECISIONS TO DECEASED DONEES

BY DEVIN S. FOX, ESQUIRE | KMS LAW OFFICES, LLC

Death and taxes are inevitable, but how and when they will apply is often unpredictable, especially in an estate planning context. A well-crafted estate plan addresses both of these realities based on present facts and circumstances and those which are reasonably expected to occur at some point in the future. The plan should be revisited when personal and financial circumstances and tax and estate laws change assuming an opportunity exists for a client to do so.

In formulating an estate plan, preliminary discussions usually focus on a client’s current asset statement and the present and anticipated needs of his or her beneficiaries. Once these have been accounted for and a basic framework for disposition of assets has been established, it is the role of the estate attorney to plan for hypotheticals and outcomes which may not be reasonably foreseeable. This may include the mental or physical disability of an otherwise healthy and independent beneficiary, the divorce of a happily married child, or economic and legal changes which could occur after the client’s death. If a client has not already decided that incorporating a trust into his or her planning is appropriate, it is usually at this point that a client will decide to err on the side of caution and plan for these unknowns by utilizing a trust to protect the inherited assets for his or her beneficiaries, particularly where significant wealth is involved.

For estate attorneys, one of the most versatile and efficient tools for building flexibility into long-term or multi-generational trusts has been the power of appointment. Boiled down to its most basic definition, a power of appointment is a right created and given by a donor to another individual, known as the “donee”, usually under a trust instrument, which empowers the donee to dispose of an interest in property of which the donor has the right of disposition.1

By granting a power of appointment to the donee, the donee is able to modify the disposition of trust assets to accommodate the facts and circumstances as they exist at that time, usually after the death of the donor, or in the case of a power of appointment granted over assets in an irrevocable trust, after the trust has become irrevocable. Such a power permits substantial post-mortem planning and the opportunity to change the recipient and manner of disposition of inherited assets if the donee determines such change is warranted.

A well-drafted provision creating a power of appointment will specify the timing and manner of its exercise and indicate how the property subject to the power should be disposed of if the power is not exercised. Like all drafting techniques, the use of powers of appointment raises certain issues the scrivener should be aware of and address prior to drafting, through discussion with his or her client.

POWERS OF APPOINTMENT, CONTINUED

One such issue is whether the donee shall be required to survive the donor in order to exercise the power of appointment granted to him or her. As mentioned above, the underlying rationale for granting a power of appointment is to allow the donee the opportunity to modify the disposition of trust assets when such modification can no longer be accomplished by the donor. For this reason, the grant of a power of appointment to a donee will usually be made contingent by its terms upon the donee surviving the donor. If the terms of the grant do not so specify, however, whether a purported exercise of a power of appointment by the donee made before the power has been created will be effective.

In order to illustrate analysis of this issue, assume that Ann executes a Will which includes a provision giving Bob a testamentary power of appointment over assets of a trust created under her Will but does not specify whether Bob must survive Ann in order to exercise the power. Bob dies before Ann having executed a Will which purports to exercise this power. Since Ann created this power by the terms of her Will, Bob’s exercise of this power will be ineffective because he died before creation of the power. A power of appointment created in a donor’s Will is deemed created on the date of the donor’s death, when the Will becomes legally operative and grants the power to the donee, rather than upon the date of its execution. The donee’s death before creation and grant of the power therefore precludes his exercise of the power.

Assume that instead of including the provision giving Bob a power of appointment in her Will, Ann opted to include this provision in the terms of her Revocable Agreement of Trust. Bob dies and Ann does not revoke or amend the terms of the Agreement of Trust before her death. Will there be a different result?

A power of appointment created by trust instrument executed by the donor is generally considered to have been created as of the effective date of the trust instrument. The power is not considered to be created at a future date merely because it is not exercisable on the trust instrument’s effective date, because it is revocable, or because the identity of its holders may not be ascertainable until after the date the instrument takes effect. Unlike the analysis above, the provision creating the power became effective when the trust instrument was executed. If the trust instrument does not condition grant of the power on Bob surviving Ann, doesn’t it follow that creation of the power prior to Bob’s death will permit him to exercise it under his Will? There is unfortunately very little law on this issue in Pennsylvania. Therefore, the intention of the donor will control construction of the power of appointment. Absent statutory or case law on this issue, Ann’s intent will determine whether the exercise by Bob of the power of appointment will be effective.

On one hand, an argument may be made that Ann could have amended the terms of the trust instrument if she did not intend for Bob’s exercise of the power to be effective and that her failure to do so indicates her intent that Bob’s survival was not required for valid

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2. 26 C.F.R. § 20.2041-1(e).
3. 26 C.F.R. § 20.2041-1(e).
4. In re O’Reilly’s Estate, 371 Pa. 349, 352, 89 A.2d 513, 514 (Pa. 1952) (“In determining which laws will govern the exercise and interpretation of [a] power [of appointment], the laws of the jurisdiction in which the donor was domiciled at the time the power was created will govern.”)
POWERS OF APPOINTMENT, CONTINUED

exercise of the power.\(^6\) A contrary argument may be made that Ann intended for the trust instrument to be a Will substitute and assumed that if Bob predeceased her, he would be unable to exercise the power. In particular, given the purpose of granting a power of appointment, it seems more likely that Ann would not intend for Bob, in the case of the power granted by her revocable trust instrument, to be able to effectively exercise the power while she is still alive and able to modify the disposition of trust assets herself.\(^7\)

Section 7602(d) of the PEF Code appears to support the conclusion that a donee’s exercise of a power of appointment granted by the donor’s Will will be ineffective if the donee predeceases the donor. It provides that absent evidence of contrary intent in the instrument creating a testamentary power of appointment or in the instrument exercising the power, the instrument exercising the power dated before the power was granted will be effective to exercise a power of appointment existing at the donee’s death.\(^8\)

Applying this statute to the fact pattern above, if the Bob died before the power was created and granted, it did not exist at his death and therefore could not have been exercised by Bob under his Will.

The result under Section 7602(d) to some degree conflicts with the theory that the exercise of a power of appointment will be made by a donee based on facts and circumstances not observed or anticipated by the donor in that it permits an instrument executed before a grant of the power to effectively exercise the power, so long as the donee is alive at its effective date. This conflict may be reconciled, however, if the donee’s failure to amend or revoke the instrument after the power becomes effective is evidence that the donee considers the terms of his or her exercise of the power to still be appropriate given facts and circumstances existing after the donor’s death.

Returning to the fact pattern above where Ann includes the provision creating the power of appointment for Bob in her Will and Bob predeceases her, there are alternative theories which may give effect to Bob’s direction in his Will purporting to exercise this power, namely incorporation by reference and independent significance. As mentioned above, the intention of the donor controls construction of the power of appointment.

If Bob’s Will existed at the time Ann’s Will was executed, and is clearly identified in her Will, it may be considered to have been incorporated into Ann’s Will by reference, which would be evidence that she intended for Bob to dispose of the assets subject to the power regardless of whether he survived her.\(^9\)

Although this conflicts with the rationale for granting the power of appointment, other reasons may exist for the donor to want a third party to decide how best to dispose of trust property, regardless of the timing of their exercise of the power. One example may be where the property subject to the power was given to the

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\(^6\) This argument would undoubtedly be even stronger if the Agreement of Trust signed by Ann was Irrevocable as of the date of its execution or became irrevocable at a later point prior to Bob’s execution of his Will.

\(^7\) The Restatement (Third) of Property (Wills & Donative Transfers), which has been neither adopted nor rejected in Pennsylvania, takes the former position that a power of appointment is created as of the effective date of the trust and can be exercised by a document executed before or after such date. Restatement (Third) of Property (Wills & Don. Trans.) § 19.11 (2011).


\(^9\) Clark v. Dennison, 283 Pa. 285, 129 A. 94, 95 (1925) (“Reference in a Will to an extrinsic document...incorporates the latter as part of the Will itself, provided it is clearly identified and in existence at the time the Will was written.”)
Powers of Appointment, Continued

donor by the donee during the
donor’s lifetime, such that the
donor believes the donee should
be able to dispose of the property
when he or she is no longer
deriving use and benefit from
such property. Another example
may be where the donee does
not have descendants or other
relatives whom the donor would
anticipate to receive the donee’s
share but wishes for the donee
to decide how his or her share
should pass just the same as same
as the donee would if he or she
had survived to receive the share
set aside for him or her under the
donor’s Will. If the donor has such
intentions, prudent drafting would
require that specific language
be included in the donor’s Will
to clearly evidence the donor’s
intent that the donee shall not
be required to survive the donor
in order for any exercise by the
donee, by instrument dated before
or after the donor’s death, to be
effective.

Another issue which should be
addressed by the scrivener is how
the property subject to the power
of appointment will pass if the
donee survives, but fails to exercise
the power of appointment.

The instrument creating the power
should indicate how and to whom
this property will pass if the donee
does not exercise his or her power
of appointment. If such provision
has not been made, property
subject to a general power of
appointment (also known as a
“broad” power of appointment)
will revert to the donor or the
donor’s estate. If the property
is subject to a special power of
appointment and no takers in
default have been identified, the
property subject to the power will
be distributed to the members of
the class of appointees as if there
were an implied gift to all of its
members.

Given their utility and common
usage, careful attention should
be given when drafting provision
creating and exercising powers
of appointment even if statutory
and case law would yield the
same result. As the above
examples illustrate, short sighted
drafting of provisions for powers
of appointment may yield
disappointing results and undercut
the benefits such powers can
provide. The best practice would
be to plan for hypotheticals
and outcomes resulting from
creation and exercise of powers
of appointment as the estate
attorney does with the rest of the
client’s plan.

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FEDERAL ESTATE TAX

Family Limited Partnership Estate Inclusion

Estate of Powell, 148 T.C. No. 18 (May 18, 2017)

In a divided decision, the Tax Court, granting partial summary judgment to the IRS, found that a decedent who, acting with a limited partnership’s other partners, dissolved a limited partnership and transferred the assets to a charitable lead annuity trust (CLAT), exercised a right “to designate the persons who shall possess and enjoy” the assets of the limited partnership and thereby subjected those assets to estate inclusion under IRC § 2036(a)(2). The Court further held that the value of the assets transferred to the limited partnership by the decedent on her deathbed was includible in the value of her gross estate under IRC § 2036(a)(2) or IRC § 2035(a). However, the Court held that, under IRC § 2043(a), only the difference between the value of the assets the decedent transferred to the limited partnership and the value of the limited partnership interest she received in return was includible in the value of her gross estate. Finally, the court held that the transfer from the limited partnership to a CLAT by the agent under decedent’s power of attorney was not valid under California state law because California law requires a grant of explicit authority in the POA to permit the agent to make gifts.

One week before the decedent’s death on August 15, 2008, her son, acting as agent under her power of attorney, transferred $10 million in cash and marketable securities from her revocable trust to a limited partnership in exchange for a 99% limited partnership interest. Decedent’s sons, who contributed an unsecured note payable to the limited partnership in return for a general partnership interest, were the only other owners of the limited partnership. On the same day, the son transferred the limited partnership interest to a CLAT, under whose terms an annuity was to be paid to decedent’s private foundation for the rest of her life and the remainder was to be equally divided between her two sons. The power of attorney authorized the agent to make gifts, limited to the federal gift tax annual exclusion amount, only to decedent’s issue. The transfer to the CLAT was reported on a federal gift tax return, with a 25% discount for lack of control and lack of marketability applied to the value of the limited partnership interest.

Decedent’s estate conceded that the decedent’s power to terminate the limited partnership with the consent of her sons could be considered a retained right under IRC §2036(a)(2) and that the transfer of cash and marketable securities to the limited partnership had no business rationale.

The IRS claimed deficiencies in both the federal gift and federal estate tax under the retained rights doctrine in IRC §2036(a) (1) and (2) and IRC §2038(a) because of (1) the existence of an implied agreement allowing the decedent to possess and enjoy the assets during her lifetime and (2) the ability of the decedent and general partners, acting unanimously, to dissolve the limited partnership and determine who would possess and enjoy the transferred property.

The IRS also claimed, and the Court agreed, that the transfer of the decedent’s limited partnership interest into the CLAT was disallowed because the transfer exceeded the annual gift tax exclusion amount allowed in her power of attorney and that, in any case, the transfer was invalid under the three-year rule of IRC §2035(a).

In calculating the amount of gross estate inclusion, the Court applied IRC §2043(a) to limit the possibility

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of double taxation of the same economic interest.

**Art Appraisal: Conflict of Interest**

_Estate of Kollsman v. Commissioner, T.C. Memo 2017-40 (February 22, 2017)_

The Tax Court upheld an IRS assessment of a deficiency in the valuation of two Old Master paintings, Pieter Brueghel the Younger’s Maypole and Jan Brueghel the Elder’s Orpheus, for federal estate tax purposes. The estate of an art collector had relied on the opinion of an auction house specialist who significantly undervalued the artworks in order to curry favor with the executor, who was to inherit the paintings. The auction house specialist had a conflict of interest because he was trying to win the right to auction the works.

Sotheby’s valuation, based on first-hand inspection, of Maypole as $500,000 and Orpheus as $100,000 was reported to the IRS on the federal estate tax return. At the same time, in a letter to the executor proposing that he handle the auction of the works, he estimated that he could sell the first work for an amount between $600,000 and $800,000 and the second work for an amount between $100,000 and $150,000. The executor gave Sotheby’s a five-year exclusive right to auction the paintings. While the paintings were being cleaned, Maypole was insured for $2 million and Orpheus was insured for $500,000. Maypole was eventually sold for $2.4 million.

The IRS issued a notice of deficiency stating that the value of Maypole was $2,100,000 and the value of Orpheus was $500,000. The Tax Court, largely accepting the IRS valuations, found that Sotheby’s opinion of the value of the artworks was not reliable because it stood to earn a large commission from their sale and therefore had an incentive to “lowball” its estimates of their value. Furthermore, the Court found that Sotheby’s had exaggerated the dirtiness of the paintings and the risk of cleaning them.

**Graegin Loan**

_Estate of Koons v. Commissioner, 11th Cir. (not for publication) (April 27, 2017)_

The Eleventh Circuit affirmed the decision of the Tax Court to deny a federal estate tax administrative expense deduction for future interest payments which were expected to be made on a Graegin loan, finding that the subject estate did not incur the loan “actually and necessarily.”

The decedent’s $200 million estate consisted of liquid nonprobate assets, primarily stock in a closely held LLC held in a trust. The liquid assets of the estate outside of the trust were insufficient to pay the estimated estate tax liability of $43 million. The estate borrowed $10.75 million from the LLC to avoid a forced sale of its stock and to be able to continue to make investments in the operation of the LLC. In exchange, it received a promissory note with an annual interest rate of 9.5%. The estate took a $71 million administrative expense deduction on its federal estate tax return for future interest payments, which were to be made with distributions from the LLC.

The Court based its decision to uphold the Tax Court’s decision in the Graegin case, in which the estate’s lack of liquidity made it necessary to obtain a loan to pay its estate tax liability. Here, the Court found that the interest payments were not actually and necessarily incurred because the estate had no shortage of liquid assets and would repay the loan using the very same assets (LLC distributions) that could have been used to pay the estate tax to begin with. The estate had not convinced the Court that the loan assisted with the administration of the estate, which would need to stay open for another 25 years to finish repaying the loan.

**Tax Collection and Lien**

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The Tax Court upheld the decision of the IRS Office of Appeals in holding that the IRS did not abuse its discretion in choosing whether to pursue the collection of delinquent federal estate tax from beneficiaries of probate or nonprobate assets of the estate. It also held that the IRS did not need to file a special estate tax lien under IRC §6324(a)(1) against nonprobate assets because under Treasury Regulation §301.6324-1(a)(1), the lien attached automatically upon the date of death of the decedent, whether or not the property ever came into the administrator’s possession. The Court also found that, although the special estate tax lien lapsed after ten years, the period for asserting IRC §324(a)(2) transferee liability may still be open.

The estate had made installment payments under IRC §§6161 and 6166 for many years, but an unpaid delinquency of $320,289 remained because certain parcels of land in the probate estate were unsalable. The IRS refused to agree to the estate’s offer in compromise and did not pursue collection against available non-probate assets before the expiration of the statute of limitations. Instead, it levied on probate assets.

Abatement of Late Filing Penalty


The District Court found that the executors of an estate reasonably relied on the erroneous advice of counsel in the late filing of the estate’s federal estate tax return.

Because of a dispute over the valuation of the estate assets among the five beneficiaries of the estate, the estate’s attorney filed IRS Form 4768 and obtained a six-month filing extension and one-year payment extension of the estate’s federal estate tax. The estate’s attorneys incorrectly advised the executors that both the estate tax filing date and the tax payment had been deferred for one year. The estate paid $900,000 on February 12, 2013, prior to the extended payment deadline, but did not file the federal estate tax return until July 2, 2013, at which time it was six months late. The IRS assessed a late-filing penalty of almost $200,000, with interest of $17,000.

The Court found that the executors’ exercise of ordinary business care and prudence in relying on their attorney’s advice, in addition to their timely payment of $100,000 more than the tax that was eventually due, constituted reasonable cause to abate the assessment of late filing penalties and interest.

FEDERAL GIFT TAX AND GST TAX

Applicable Exclusion Amount and GST Tax Exemption for Same-Sex Couples


This Notice provides additional guidance in the application of United States v. Windsor, 570 U.S. ___, 133 S. Ct. 2675 (2013) and Revenue Ruling 2013-2017. It sets forth the procedures for recalculating the remaining applicable exclusion amount and GST tax exemption when such exclusion or exemption was allocated to taxable gifts and bequests to taxpayers in same-sex marriages which were valid under state law, allowing taxpayers in such marriages to recoup lost applicable exclusion amounts and GST tax exemptions.

The Notice states that, regardless of the domicile of the parties and even if the statute of limitations has run on the return in question, if a couple was married when one spouse made a gift to the other spouse or a transfer upon the death of one spouse, the couple can file an amended federal gift tax return or a supplemental federal estate tax return to claim the unlimited marital deduction for federal gift and estate tax purposes. Whether or not a new or amended federal gift tax return should be filed depends

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TAX UPDATE, CONTINUED

on whether the limitations period has expired. If the statute has run, couples cannot file a claim for refund or a claim for taxes paid after the expiration date. Also, no changes to valuation are permitted and the failure to split gifts cannot be corrected.

The Notice also provides that allocation of GST exemption to transfers that ignored the family relationship of same-sex spouses and did not use familial generational assignments in determining who qualified as a skip person will be restored by voiding the existing allocation of GST exemption and recalculating the exemption remaining to the taxpayer even if the limitations period has run. The Notice states that this recalculation is “limited to the recalculation of the taxpayer’s GST exemption that was allocated to a transfer to (or to a trust for the sole benefit of) one or more transferees whose generation assignment for purposes of that exemption allocation should have been determined on the basis of familial relationship as the result of the Windsor decision, and who therefore are non-skip persons.”

The IRS will release a new worksheet and instructions in order to allow taxpayers who made gifts to a same-sex spouse to file a new or amended federal gift tax return, depending on whether the statute of limitations has run. The taxpayer can file either a Form 709, an amended Form 709, or Form 706, as the case may be.

IRS PROCEDURES

Suspension of Private Letter Rulings and Conferences with the IRS

According to Charles (Chuck) Rubin’s blog on JD Supra Business Advisor dated 3/8/2017, at a recent Federal Bar Association Tax Law Conference an IRS Chief Counsel branch chief announced that due to budget cuts, the IRS has temporarily suspended (a) the issuing of private letter rulings concerning modifications to GST exempt trusts and (b) conferences with taxpayers concerning federal estate, gift and GST tax issues prior to the submission of a request for a private letter ruling.

Changes to Estate Tax Lien Process

An estate owning realty must file Form 4422 (Application for Certificate Discharging Property Subject to Estate Tax Lien) with the IRS if it wishes to transfer real property before filing a federal estate tax return. On April 5, 2017, the IRS issued an internal memorandum concerning the processing of requests for discharging estate tax liens. In the case of an estate wishing to transfer property before filing its federal estate tax return, IRS agents are directed to consider whether the estate has enough assets to provide for its estate tax liability, either through prior payment of estimated federal tax or through the escrow of the proceeds from the transfer of real property that are equivalent to the federal estate tax liability. No escrow is necessary if no federal estate tax is due upon the discharge of the lien. It is no longer necessary for the entire net proceeds from the sale of the property to be deposited into an escrow account or into the estate’s IRS estate tax account. It is also no longer necessary for the final determination of tax to be made before the release of the escrowed sale proceeds.

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CASE SUMMARY FROM THE ORPHANS’ COURT LITIGATION COMMITTEE


BY ASHLEY ROTCHFORD, ESQUIRE | HECKSCHER, TEILLON, TERRILL & SAGER, P.C.

A recent decision from the Superior Court of Pennsylvania recognized same-sex common law marriage in Pennsylvania, provided such common law marriages were entered into before 2005 and met the requirements set forth in Staudenmayer v. Staudenmayer, 714 A.2d 1016 (Pa. 1998) (holding that a party claiming a common law marriage must produce clear and convincing evidence of the marriage contract). This case reinforces a series of earlier lower court decisions in Pennsylvania that also found pre-2005 same-sex common law marriages to be valid. This recognition of same-sex common law marriage confirms rights of same-sex couples, specifically those who never had the chance to formally marry, to receive the benefits and responsibilities that Pennsylvania already conferred onto opposite-sex married couples, including inheritance rights.

In Estate of Stephen Carter, the decedent (“Decedent”) and his partner (“Petitioner”) were in a 17-year same-sex relationship. They met in February 1996 and began living together just a few months later in Philadelphia. In late 1996, Petitioner proposed to Decedent with a diamond ring, which Decedent accepted. A few months later, Decedent gave Petitioner a ring with the date February 18, 1997 inscribed on it. The couple celebrated an anniversary on that date each subsequent year. In April 2013, Decedent died. Three years later, in 2016, Petitioner sought a declaration that he and Decedent were in a common law marriage prior to January 1, 2005. No one opposed Petitioner in seeking this declaration, and Decedent’s family supported Petitioner.

The Beaver County Orphans’ Court denied the petition on two grounds. First, the Orphans’ Court considered it a legal impossibility to recognize a common law marriage that would not have been legal at the time it was entered into. Second, even if it were legal, Petitioner failed to establish that he and Decedent were in a common law marriage. The trial court based this conclusion on the testimony of Petitioner and others that Petitioner and Decedent wished to have a formal wedding ceremony after same-sex marriage was legalized in Pennsylvania.

Petitioner appealed the trial court’s decision, arguing that Pennsylvania should recognize same-sex common law marriages in light of recent decisions regarding marriage rights, and that he presented sufficient evidence to show that he and Decedent were in a common law marriage prior to 2005. The Superior Court agreed.

The Superior Court first addressed the trial court’s claim that same-sex common law marriages could not enter into common law marriages prior to 2014 because same-sex marriage was not recognized in Pennsylvania prior to that date. The trial court

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

2 A link to the opinion can be found here: http://www.pacourts.us/assets/opinions/Superior/out/J-A05040-17o%20-%2010306606816961022.pdf?cb=1.

3 © 2017 Heckscher, Teillon, Terrill & Sager, P.C. All Rights Reserved. Ashley Rotchford is a law student at Temple University Beasley School of Law (J.D. expected 2018) and is a summer associate at Heckscher, Teillon, Terrill & Sager, P.C.

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CASE SUMMARY, CONTINUED

Pennsylvania law only recognized marriage between a man and a woman. The Superior Court was quick to dismiss this claim by stating that courts cannot rely on unconstitutional laws to preclude common law marriage. The court noted that in 2013, there was a shift towards recognizing same-sex marriage at the state and federal level that resulted in the abrogation of “defense of marriage” statutes nationwide. “Together, Windsor, Whitewood, and Obergefell teach that same-sex couples have precisely the same capacity to enter marriage contracts as do opposite-sex couples, and a court today may not rely on the now-invalidated provisions of the Marriage Law to deny that constitutional reality.” Carter, Slip. Op. at 13.

The Superior Court, therefore, started its analysis of the right of same-sex couples to be in recognizable common law marriages by providing an in-depth look into the evolution of same-sex marriage at the federal and state level.

The court began with Windsor, in which the United States Supreme Court held that the provision of the Defense Of Marriage Act (“DOMA”) defining marriage as between a man and a woman violated the Due Process Clause of the Fifth Amendment of the U.S. Constitution. U.S. v. Windsor, 133 S.Ct. 2675, 2695 (2013). The Court reasoned that “DOMA’s unusual deviation from the usual tradition of recognizing and accepting state definitions of marriage … operates to deprive same-sex couples of the benefits and responsibilities that come with the federal recognition of their marriages.” Id. at 2693.

Then the Superior Court looked to Whitewood v. Wolf, a Middle District of Pennsylvania case that struck down Pennsylvania’s Marriage Law as violative of the Fourteenth Amendment, based on the precept that same-sex couples have the same fundamental right to marry as opposite-sex couples.4 992 F.Supp. 2d 410, 423-24 (M.D. Pa. 2014). In its ruling, the Whitewood court emphasized that “the right Plaintiffs seek to exercise is not a new right, but is rather a right that these individuals have always been guaranteed by the United States Constitution.” Id. at 423. Quoting Whitewood, the Superior Court noted:

[Those who drew and ratified the Due Process Clauses of the Fifth Amendment or the Fourteenth Amendment] knew times can blind us to certain truths and later generations can see that laws once thought necessary and proper in fact serve only to oppress. As the Constitution endures, persons in every generation can invoke its principles in their own search for greater freedom. Id. at 423.


In addition, prior to this matter reaching the Superior Court, several lower courts in Pennsylvania had already recognized the right of same-sex couples to be in common law marriages that commenced prior to 2005, including In re Estate of Wilkerson, No. 500 DE of 2016 (O.C. Phila. Sept. 25, 2016) (same-sex common law marriage existed as of July 4, 1990). Looking to this precedent at the federal and state level, the Superior Court concluded that same-sex couples had the right to enter into common-law marriages prior to 2005 in Pennsylvania.

The court then addressed whether Petitioner and Decedent fulfilled the necessary elements to be in a common law marriage. Even before 2005, courts in Pennsylvania did not look kindly upon common law marriage “[b]ecause claims for the existence of a marriage in the absence of a certified ceremonial marriage present a ‘fruitful source of perjury and fraud.’” Staudenmayer, 714 A.2d at 1019. Relying on the standards set forth in Staudenmayer, the court noted

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4 Same-sex couples’ fundamental right to marry was later recognized by the U.S. Supreme Court in Obergefell, 135 S.Ct. 2584 (2015).
that Petitioner must show by clear and convincing evidence that he and Decedent had entered into a legal relationship. To do so, Petitioner must show a present intent to marry prior to 2005.

In its analysis, the court focused on the uncontradicted testimony of Petitioner and others, who testified in support of Petitioner. Specifically, the court focused on the fact that Petitioner and Decedent exchanged rings and celebrated their wedding anniversary on the same day every year. The court noted that the exchanging of rings is strong evidence of a present intent to marry. See, e.g., Estate of Wagner, 159 A.2d 495, 498 (Pa. 1960).

While recognizing that same-sex couples are subject to the same standards of proving a common law marriage as opposite-sex couples, the court found nothing in the facts that indicated perjury or fraud.

Furthermore, the court addressed the trial court’s emphasis on the testimony that Petitioner and Decedent were planning a formal wedding ceremony. Noting that “the couples statements about a future ‘wedding’ or ‘big party’ plainly referred to a ceremonial marriage … which is fully consistent with an existing common law marriage,” the court concluded that Petitioner satisfied his burden of proving by clear and convincing evidence that he and Decedent entered into a common law marriage prior to 2005. Carter, Slip Op. at 22.

In conclusion, the court reversed and remanded the case to the trial court for entry of an order declaring a common law marriage between Petitioner and Decedent as of February 18, 1997.

HAVE IDEAS OR TOPICS FOR AN ETHICS COLUMN?

Send your questions and ideas to:

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