Happy Spring to ALL! I am pleased to report that the work of our Section and its committees is well underway. This year promises to be a year of growth for our Section and I am pleased to announce a new initiative and the genesis of a new Committee. Our new initiative, ably chaired by Alison Altman Gross, (our Young Lawyers Division liaison) is designed to entice newer practitioners to our Section and its committees and to encourage their active involvement. We have hosted one meeting as an introductory session attended by 36 attorneys with fewer than 10 years experience in the practice. Based on survey responses, there is great interest in re-creating the luncheon discussion groups and 3 new groups have been started. In addition, there will be a Probate Section YLD listserv, and the group has been asked to hold a joint happy hour with the young lawyers of the Tax Section. Kudos to Alison!

Our new committee, organized and chaired by Dennis Reardon will focus on business planning. The committee is still in its formative stage but stay tuned for an announcement regarding meeting dates and times.

Earlier this year I was fortunate to participate in the Bar Leaders Retreat in Atlantic City. Despite the snow filled weekend, there were many interesting sessions, and it is clear that the Bar has many dedicated members. One particular session of note was a panel discussion about diversity in the profession. The new Director of Diversity, Naomi McLauren, challenged the group to deal with issues of diversity and encouraged all of the Sections and Committees to adopt a diversity policy. Naomi will be attending a session of the Executive Committee later this year.

I would be truly remiss if I neglected to thank our committee chairs who work tirelessly for the good of the Section and its members. Our committee chairs for 2011 are as follows:

Education – Aaron Fox
Business Planning – Dennis Reardon

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The Clawback Risk: Uncertainty Regarding Use of the Temporary $5 Million Gift Tax Exemption

By TRACY BLAKE DEVLEIGER AND PAM H. SCHNEIDER
GADSDEN SCHNEIDER & WOODWARD LLP

In a last minute “deal” at the end of 2010, Congress derailed the scheduled sunset of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), deferring the reversion to a $1 million estate tax exemption and 55% maximum federal estate, gift and GST rates until 2013. To the surprise of many in the estate planning community, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“TRA 2010”) changed the reach of federal transfer taxes in a way that opened up a whole new world of opportunities to estate planning clients for at least two years by, inter alia, increasing the gift, estate and generation-skipping transfer (“GST”) tax exemptions to $5 million and reducing the top rate for all three taxes to 35% for two years. The temporary nature of these changes, along with the proven unpredictability of Congress, has created something of a “going out of business sale” atmosphere among estate planners. Clients are being urged, appropriately, to consider making transfers in 2011 and 2012 to take advantage of the increased exemptions and lower rates while they last.

However, TRA 2010’s two year patch left unanswered questions concerning the post-2012 effect of the use of temporarily increased exemptions in 2011 and 2012. Perhaps the most important of these (or at least the most universally applicable) is the “clawback problem,” which relates to the increase in the gift tax exemption. Unfortunately, while many are predicting that the problem will never materialize because Congress or the Internal Revenue Service will “fix” it, given the inherent unpredictability of our tax laws, we believe it crucial that planners understand the scope of the problem.

1 See § 901(a)(1), (b) of Act June 7, 2001, P.L. 107-16 (26 USCS § 1 note), as amended by § 101(a) of Act Dec. 17, 2010, P.L. 111-312 (26 USCS § 121 note).

2 The top estate, gift and GST tax rate were scheduled to revert to 55% (60% for estate and gift transfers between $10 million and $17,184,000) effective January 1, 2011.

Report of the Chair, continued

Elder Law – Keelin Barry
Legislative – Michael Stein
Orphans’ Court Litigation and Dispute Resolution – Timothy Holman
Publications – David Ruben
Rules & Practice – Bernice Koplin
Tax – Don DiCarlo

Thank you to these hard-working individuals and their committees. If you are not on a committee, please consider volunteering to serve – as with many volunteer activities – you often benefit more than anticipated! Thank you also to those who serve as liaisons for our Section: Alison Gross – YLD; Paul Irwin - Corporate Fiduciaries; Judy Stein – Board of Governors; Jay Foster – Legislative; and Jon Sokoloff – Tax Section.

Finally, thank you to Rob Friedman our immediate past chair who has served this Section in many ways – thank you for your leadership, your guidance and friendship. Also, thanks to the current officers with whom I will have the pleasure of serving this year – Bob Louis, Chair-Elect; Susan Collings, Vice Chair; and Karen Stockmal, Secretary. We are all looking forward to an exciting and productive year.
The Clawback Risk, continued

factor it in to their estate planning recommendations and communicate the risk to clients.

The purpose of this article is to explain the clawback concern and its impact on 2011/2012 gifts, as well as to recommend that we as planners get comfortable explaining it to clients, both for their sake and for our own protection.

What is the “Clawback” Problem?

Unless Congress acts, on January 1, 2013, following TRA 2010’s scheduled sunset, the estate and gift tax exemption will revert to $1 million, and the GST exemption will be $1,360,000, further adjusted for inflation in 2011 and 2012. 3 It is not clear how a taxpayer who makes gifts during 2011 or 2012 using the additional gift tax exemption available in these years will compute his or her estate tax liability after 2012 if Congress does not act to extend the $5 million gift tax exemption or to otherwise clarify this issue. Just as guidance and forms for 2010 transfer tax reporting and basis allocation are slow to appear, we may be well into 2013 before we have a clear picture of how the first-ever transition to a deceased gift and estate tax exemption will operate in 2013 and beyond. In particular, there is a concern that the method of computing one’s federal estate tax will result in a payment at death of an estate tax on the portion of those lifetime gifts during 2011 and 2012 that escaped gift tax due to the 2010 Act’s increase of the gift tax exemption from $1 million to $5 million.

The problem arises because under IRC section 2001(b) as in effect before 2011 and after 2012) a decedent’s estate tax liability is generally determined as follows:

1. First a “tentative tax base” is determined by adding to the decedent’s taxable estate all post-1976 taxable gifts;

2. The estate tax rate table is applied to this number to determine a “tentative tax.”

3. Next, a hypothetical “gift tax payable” is calculated on the post-1976 taxable gifts that were added to determine the tentative tax base;

4. The gift tax payable so calculated is then subtracted from the “tentative tax;” and

5. Finally, the estate tax exemption and any other applicable credits are applied to determine the estate tax liability.5

The clawback, if it exists, stems from the method of determining the “gift tax payable,” the third step above. The Internal Revenue Code (“Code”) is clear that the “gift tax payable” to be deducted from the tentative tax is not the amount of gift tax actually paid when the post-1976 gifts were made, but rather the amount that would have been paid if the estate tax rates in effect at the date of the gift had been applicable to the gifts. In a new section 2001(g), the Code is explicit that for 2011 and 2012, gift tax payable is determined based on the estate tax rates in effect at death. There is no doubt that the gift tax credit is taken into account in determining the gift tax payable under the rates in effect at death. However, neither in section 2001(g) nor elsewhere does the Code specify whether it is the credit available at the time of the gift or the credit available at the time of death that should be used to calculate gift tax payable under the rates in effect at death. This is the issue which could potentially cause the clawback -- if the credit at the time of death is lower than at the time of the gift.

The instructions to the 2009 federal estate tax return (Form 706) 5 provide that the credit based on the exemption in effect at the date of the gift should be used in calculating gift tax payable. This approach is appropriate when the credit on the date of the gift is less than or equal to the credit available at death, as was the case when the instructions were written and at all times prior to this year. However, for the first time, TRA 2010 created the possibility that the gift tax credit allowed at the time of a gift (tied to the $5 million exemption in 2011 or 2012) may be larger than that available at the time of death (based on an exemption of $1 million as of January 1, 2013, or some other lower number subsequently enacted). Under these circumstances, determining “gift tax payable” by reference to the credit at the time of the gift causes a clawback.

3 Other changes made in EGTRRA and TRA 2010 will sunset on December 31, 2012 as well, including the maximum tax rate, which will return to 55%, with an effective rate of 60% for estates between $10 million and $17,184,000 to eliminate the benefit of the graduated rate schedule for larger estates.

4 See, e.g. PLR 9250004.

5 Form 706 Instructions, page 5 regarding Line 7 Worksheet column (e).

continued on Page 4
The Clawback Risk, continued

Consider the following example:

Assume A, who has never before made any taxable gifts, makes a $5 million gift in 2011, using his entire gift tax credit and then dies in 2015 with a $15 million estate. Assume further that in 2015 the estate tax credit is again determined by an exemption of $1 million and the top tax rate has gone back to 55% (ignoring for purposes of this example the effect of the 5% bump on estates between $10 million and $17,184,000). If the current instructions to the 2009 (and earlier) estate tax return are followed, the tax on A’s $15 million gross estate would be over $10,650,000, computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Estate</td>
<td>$15,000,000</td>
</tr>
<tr>
<td>Plus: adjusted taxable gifts (all from 2011)</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Tentative tax base</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Tentative tax using date of death rates (assume flat 55%)</td>
<td>$11,000,000</td>
</tr>
<tr>
<td>Less gift tax payable on 2011 gift using date of death rates AND, per instructions, the credit determined as of date of gift</td>
<td>$0</td>
</tr>
<tr>
<td>Estate tax before credits</td>
<td>$11,000,000</td>
</tr>
<tr>
<td>Maximum credit against estate tax at date of death (assumes exemption equivalent of tax on $1,000,000)</td>
<td>$345,800</td>
</tr>
<tr>
<td>Federal estate tax</td>
<td>$10,654,200</td>
</tr>
</tbody>
</table>

Without the clawback, the estate tax would be no more than 55% of the $15 million remaining at death, or $8,250,000. This would be the result if “gift tax payable”, the reduction amount at line 7, reflected a $1 million exemption, rather than a $5 million exemption. With the clawback, the effective rate of tax on the remaining estate of $15,000,000 is $10,654,200/$15,000,000 or 71%.

Will the clawback problem be solved?

From a predictive standpoint, we may draw some comfort from the detailed treatment of the changing credit in the 2010 gift tax realm. The recently issued 2010 Form 709 and Instructions, following the statutory changes, recognize that the reduction of the gift tax rate to 35% reduced the credit reflected by a $1,000,000 exemption and requires a methodical recalculation of the previously utilized gift tax credit at rates over 35% to restore the appropriate remaining credit available. For deaths in 2011 and 2012, section 2001(g) will appropriately convert lifetime use of credit to the 35% rate ($1,575,000 on $5,000,000) so that gift tax payable on those gifts is not overstated. Unfortunately, although it is hard to imagine that Congress intended to take away any portion of the benefits of the increased exemption used in 2011 and 2012, Congress was not as careful to make sure that exemption would not be clawed back on the donor’s death after that date.

Either Congress or the IRS could prevent a clawback by making it clear that the smaller of the two exemptions...
The Clawback Risk, continued

date of gift vs. date of death is the one to be taken into account in the estate tax calculation. Ultimately, it would be reasonable to expect such a clarification, particularly as the clawback problem appears inconsistent with Congressional intent as evidenced in section 2001(g), and the sunset provision itself. Various authorities including some within Treasury have stated off the record that it is likely that the clawback problem will be eliminated when guidance is provided.

6 Unfortunately, section 2001(g) does not solve the problem, in part because it also disappears in 2013 unless Congress acts.

7 The sunset provisions of both EGTRRA and TRA 2010 operate to restore pre-existing law “as if they had never been enacted.” Section 301 of TRA 2010; Section 901 of EGTRRA. This “had never been enacted rule” causes a similar problem in connection with the generation-skipping transfer tax. See Carlyn S. McCaffrey and Pam H. Schneider, The Generation-skipping TransferTax: Time Traveling with the GST in 2011 and Beyond, 30 Trusts & Estates, Vol. 150 No. 2 (February 2011). However, it might actually provide a basis for solving the clawback problem. That is, guidance might be generated which directs preparers to calculate the hypothetical gift tax payable (the line 7 amount) on the basis of the tax that would have been paid in 2011 or 2012 had the 2010 and 2001 Tax Acts never been enacted.

What should clients be told?

In recommending 2011 and 2012 gifts, estate planners would be well-advised to counsel clients to factor in the potential for future clawback of the $5 million gift tax exemption. For many clients, the benefits of making a gift in 2011 or 2012, paying no gift tax or gift tax at a favorable rate of 35%, and removing future income and appreciation from the estate will outweigh the clawback risk. However, without such consideration, some clients, faced with an unexpected estate tax on the death of the first spouse or otherwise in the future, may question whether gifts in 2011 or 2012 would or should have been made.

While it is tempting to ignore the clawback problem on the theory that it will likely be solved and is too complicated for most clients to understand, experience counsels otherwise. To guard against a future complaint, planners should, at a minimum, warn clients about the clawback risk whenever recommending gifts in 2011 or 2012 to use the higher gift exemption before it is reduced. The significant but convoluted nature of the potential clawback risk under TRA 2010 makes this particularly challenging – but it is no different that the challenges estate planners face every day in explaining complex tax and legal issues to clients who want their attorneys to “keep it simple.”

JOIN A COMMITTEE

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

Nina B. Stryker
Obermayer Rebmann Maxwell & Hippel LLP
One Penn Center, 19th Fl.
1617 JFK Blvd.
Philadelphia, Pa 19103-1895
Nina.stryker@obermayer.com

Name: 
Address:
e-mail:

COMMITTEE PREFERENCES

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Planning for Same-Sex Couples

By MARGUERITE WEESE, J.D., LL.M. (TAX)

The laws surrounding same-sex marriage and civil unions are constantly evolving. As the laws change, so do the estate planning techniques implemented by couples. What never changes, however, is the importance of proper estate planning. This article is intended to give an overview of some planning ideas for same-sex couples.

I think it important to establish some legislative background of the estate planning environment in which same-sex couples find themselves. In 1996, President Bill Clinton signed the Federal Defense of Marriage Act (DOMA). The Act defines marriage as a legal union between one woman and one man for all federal laws. It also asserts that a state is not required to give effect to any public act or judicial proceeding of any other state recognizing marriage between persons of the same sex, if the state has determined that it will not recognize same-sex marriages.

Five states and the District of Columbia currently recognize same-sex marriage. Three states recognize civil unions. Seven states recognize domestic partnerships. Under the Full Faith and Credit clause of the U.S. Constitution, states are generally required to recognize and honor the public laws of other states, unless those laws are contrary to the strong public policy of that state. Currently three states recognize same-sex marriages that were performed elsewhere, even though that marriage could not have been performed in that state.

Pennsylvania’s statutes declare marriage to be between one man and one woman. Marriages between persons of the same sex that have been entered into in another state or a foreign country will be considered null and void in Pennsylvania. However, state employees of Pennsylvania who are in same-sex relationships are allowed to obtain the same medical benefit for their partners as hetero-

1 DOMA passed Congress as H.R. 3396 and was signed on September 21, 1996 by President Bill Clinton.


3 See id.


6 See id. The states that recognize domestic partnerships are California, Oregon, Nevada, Washington, Hawaii, Maine, and Wisconsin. See id.


8 See 23 P.C.S.A. §1704. This statute was added on October 16, 1996.

9 See id.

continued on Page 7
Planning for Same-Sex Couples, continued

sexual married employees.10 The most liberal of the Mid-Atlantic States is New Jersey, which recognizes same-sex civil unions which gives the partners of civil unions all of the same benefits, protections, and responsibilities that spouses have in an opposite-sex marriage.11 Civil union couples are allowed the realty transfer fee exemption when conveying real property between spouses.12 They are now included in the group that is exempt for New Jersey transfer inheritance tax purposes, on property having a total value of $500 or more which passes from a decedent to a beneficiary. Additionally they are allowed the presumption afforded to married couples which states that the offspring of a biological parent is presumed to be the child of the non-biological parent.13 On April 14, 2011, Delaware’s House of Representatives passed Senate Bill 30 which allows same-sex couples to enter into civil unions and attain some of the same benefits as married couples.14 This would allow same-sex couples to visit a partner in the hospital and make decisions about the partner’s medical care. Finally, Maryland recognizes marriages of same-sex couples from other states but does not allow same-sex marriages to be performed under Maryland law.15

On February 23, 2011, President Barack Obama announced that he has directed Attorney General Eric Holder to stop defending the constitutionality of DOMA in court.16 Regardless of what direction DOMA legislation will take in the future, it is important to plan around the federal law as it is today. Proper planning requires having the right estate and financial documents in place. While this is important for opposite-sex married couples, it is particularly important for same-sex couples because many of the legislative defaults only recognize opposite-sex marriages. This article will look at planning for same-sex couples during their lifetime together and wealth transfer for when one passes away.

LIFETIME PLANNING

When it comes to comprehensive planning, it’s important to know the state laws of where the couple live and work. State laws affect most of the aspects of a couple’s life together, including but certainly not limited to, the right to marry, adoption rights, hospital visitation rights, and employee benefit rights.

Power of Attorney

Powers of attorney are an

10 The PA Employees Benefit Trust Fund, which is a non-governmental agency that oversees the state benefits program, began offering benefits to same-sex partners and opposite-sex domestic partnerships on July 1, 2009. See Jen Colletta, PA Grants Domestic-Partner Benefits, May 14, 2009, Philadelphia Gay News. This includes medical, prescription drug, dental, vision, and hearing aid benefits. See id.

11 See P.L. Chapter 103, The Civil Union Act, was signed into law on December 21, 2006. The legislation was passed in response to the New Jersey Supreme Court’s decision in Lewis v. Harris, 188, N.J. 415 (2006).

12 See N.J.S.A. §46:15-10(j)


14 As of the submission of this article, the bill had yet not been signed by Governor Jack Markell.


However, the Attorney General will continue to enforce DOMA until such time that either the courts rule that it is unconstitutional or Congress repeals the law. See Nina Totenberg, U.S. Sends Conflicting Signals on Gay Marriage Law, March 1, continued on Page 8

continued on Page 8
Planning for Same-Sex Couples, continued

important part of estate planning generally, but are critical for same-sex couples. There are powers of attorney for both financial and healthcare.17 The financial durable power of attorney allows the agent to take all actions appropriate for someone of attorney allows the agent to take care.17

attorney for both financial and health sex couples. There are powers of generally, but are critical for same-sex couples whose relationship is recognized as a civil union or domestic partnership should check with their state income tax laws to determine how they may file their return. See id. Not all states allow couples to file a joint return. See id.

returns. An important benefit of having same-sex spouses sign healthcare proxies for each other is the assurance that they will able to visit the hospitalized spouse.18 Additionally, and in conjunction with healthcare proxies, it is valuable for all individuals to have a document called a living will to legally record the circumstances under which a person would like life sustaining treatments.19 This helps a person’s spouse make decisions by allowing him/her to know what a patient’s preferences are as well as helping the spouse defend his/her decision against other family members who might try to challenge the decision. In addition to a healthcare proxy and a living will, spouses should consider completing a Health Insurance Portability and Accountability Act (HIPAA) authorization form to allow the insurance company to release medical information to a spouse.20

Income Tax Returns

As complicated as filing income taxes already is, being part of a same-sex couple can make filing even harder to navigate. Pursuant to DOMA, the Internal Revenue Service (the Service) does not recognize same-sex spouses for federal income tax return purposes. If the couple lives in a state that does not recognize same-sex marriage or civil unions, then the couple files individually using single status, both on the state and federal level.21 If the couple lives in a state which allows them to file married or civil union, then the couple should be sure to indicate somewhere on their federal returns that they are married at the state level, but required to file separately and as single because of DOMA.22 Without such a disclosure, the Service may be confused that credits and taxes do not line up accordingly with the disclosed income and deductions. New for the 2010 tax season, same-

21 See I.R.C. § 6013(a). “[A] husband and wife may make a single joint return…” Id.; See also Frank S. Berall, Update on Evolving Legal Status of Same-Sex Marriages, Estate Planning Journal, (Thompson Reuters, Dec 2010). Couples can use this to their advantage by shifting income and deductions between the two returns. See Love, Marriage and Civil Unions, supra n. 5.

22 See Love, Marriage and Civil Unions, supra n. 5. Same-sex couples whose relationship is recognized as a civil union or domestic partnership should check with their state income tax laws to determine how they may file their return. See id. Not all states allow couples to file a joint return. See id.

17 There are three types of powers of attorney. The first terminates upon the incapacitation of the principal. The second is called a springing power of attorney and only becomes effective upon the principal’s incapacitation. The third is a durable power of attorney, which becomes effective at the time it is signed and remains effective until revoked or the death of the principal. While some individuals may initially gravitate towards springing powers of attorney, it is important to point out that proving incapacitation can be difficult and cause frustrating delays during an event when time is of the essence.

18 Some states legally only allow family members, as defined by state law, to visit patients in hospitals in certain circumstances. If the state does not recognize same-sex marriage or civil unions, then the spouse will not be considered family.

19 A living will may often be combined in the same document as the healthcare power of attorney. Be sure to check each state’s laws for guidance.


2011, NPR.com, http://www.npr.org/2011/03/01/134132526/us-defends-doma-despite-dropping-support?ps=rs, (last visited Apr. 26, 2011). It is the obligation of the Executive Branch to enforce the law as it applies to federal laws unless the Legislative Branch repeals the law or the Judicial Branch renders it unconstitutional. See id.
Planning for Same-Sex Couples, continued

sex couples in California, Nevada and Washington encountered an unusual interaction between state and federal laws. All three states are both community property states and states that recognize domestic partnerships.23 Community property is the legal form of ownership which attributes income and property acquired during marriage equally to both partners, regardless of who earned it.24 The Service must follow state property laws, and as a result these couples calculate their community income and split it down the middle for their federal return.25 Each partner will claim half the community income at a federal level but still file as single or head of household.26

Adoption

While states that recognize the marriages of same sex couples would presume that a child born during marriage is the child of both spouses, it is important for both parents to adopt the child to protect each person’s rights when traveling outside of that state.27 Adoption is a court judgment that creates a parent-child relationship and therefore is more likely to be respected by other states even if these states are unresponsive to same-sex couples or parenting. It will also help in the event of one parent’s death because then the child can collect social security from the federal government based on the adoptive parent relationship. While Pennsylvania does not recognize same-sex marriages or civil unions, in August of 2002, the Supreme Court of Pennsylvania ruled that same-sex, second-parent adoptions are allowed under the state’s Adoption Act.28 This example is another reason why it is important to know the state’s laws because each has its own quirks.

Looking at how adoption expenses translate to federal income tax returns, either spouse can use the adoption credit on their federal return.29 If both are parents, either biological or adoptive, then either may claim the child as a dependent for federal income tax purposes.30 It may be more beneficial for that parent to use the head of household filing status with the dependent child because that tends to have more favorable tax treatment than the single filing status.


24 There are nine states that have community property laws: Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington and Wisconsin. See Community Property, IRS Pub. No. 555, at 2 (2010).


26 See id.


29 See I.R.C. §23(i) and Notice 97-9


31 See 23 P.S.C.A § 5611. PA is one of the states that allows standby guardianship. See id.

Standby guardianships may be an option if adoption is not available or the couple wants additional legal protection while an adoption is being processed. Standby guardianships allow the biological parent to designate a standby guardian to act on behalf of that parent following a specific triggering event. This would ensure that the child could be taken care of by a non-biological parent in an emergency situation such as incapacity or death. It does not take the place of legal parenthood because it can be revoked, it may only be effective for a limited period of time and it does not confer legal parental or inheritance rights.

Titling of Real Property

There are three ways same-sex couples can own real property together: as tenants by the entirety, as tenants in common, and as joint tenants with right of survivorship. Tenancy by the entirety is only available to married couples and therefore only available in states that recognize same-sex marriages. This type of ownership affords couples the most protection from creditors because each spouse simultaneously owns 100% of the real property and has the right to possess the entire property, making it difficult to partition the property. At the death of the first tenant to die, the surviving tenant automatically becomes the sole owner without going through probate. Under tenants in common, each person owns an undivided one-half interest in the property. A tenancy in common has no right of survivorship and therefore if property is owned as such, each person must be sure to properly bequeath his/her ownership interest in the property.

Joint Tenants with Right to Partition

Tenancy by the entirety is only available in states that recognize same-sex marriages. This type of ownership affords couples the most protection from creditors because each spouse simultaneously owns 100% of the real property and has the right to possess the entire property, making it difficult to partition the property. At the death of the first tenant to die, the surviving tenant automatically becomes the sole owner without going through probate. Under tenants in common, each person owns an undivided one-half interest in the property. A tenancy in common has no right of survivorship and therefore if property is owned as such, each person must be sure to properly bequeath his/her ownership interest in the property.
Planning for Same-Sex Couples, continued

of Survivorship (JTWROS) ensures that upon the death of one partner, the other should receive ownership of the house automatically regardless of the will, state inheritance laws or claims of outside parties. The title of the property must explicitly state that they are taking ownership as JTWROS in order to ensure the right of survivorship. Unlike tenancy by the entireties, JTWROS ownership permits a creditor of one joint owner to obtain a court-ordered partition of the property and then force a sale of the indebted joint owner’s share of the property. It is important to note that when using JTWROS the entire house value will be taken into account when calculating the first to die’s estate unless the surviving partner can prove contribution to the asset up to 50% of the fair market value of the home. If the house was not originally titled JTWROS, it is important to be aware that retitling the home without contribution by the added partner might cause the Service to consider the retitling as gifting half of the value of the property.

WEALTH TRANSFER

Wealth transfer for this article encompasses all planning where intent is to pass assets, regardless of value, to specific persons. Deciding which vehicle should be used to make the wealth transfer takes into account all of the variables: the type of assets being passed on, the value of the assets, the timing of the transfer and the relationship between the original owner and the recipient. All transfers have some type of tax consequence at the federal and state level, whether that consequence is not paying any tax or paying a large amount of tax. As with income taxes, the Service does not recognize same-sex spouses for federal gift or estate tax purposes due to DOMA. Therefore same-sex spouses do not have the same benefit of gifting assets to each other free of gift tax nor do they have the benefit of the marital deduction at death. These two limitations play a huge role when dealing with planning for same-sex couples. Pursuant to the Tax Relief Act of 2010, the lifetime gifting exemption, estate tax exemption and generation skipping tax (GST) exemption amounts are at $5 million per individual for the tax years of 2011 and 2012. This increased exemption is helpful when planning wealth transfer strategies for same-sex spouses, but such couples are still at a significant disadvantage in comparison to opposite-sex spouses who have the benefit of both spouses’ exemptions, the marital deduction and tax-free lifetime transfers between spouses.

Wills

The basic foundation of wealth transfer is a person’s will. Many aspects of creating a will are universal but there are a few provisions that can be added to a will to make a same-sex spouse reassured that their spouse will receive the assets as intended. If a spouse plans to give everything or a substantial amount of his/her estate to his/her same-sex spouse, it is beneficial to specifically state that while the testator knows he/she has blood relatives, he/she is choosing to leave assets to his/her same-sex partner. This is to ensure that the decedent’s intent is clear if the will becomes contested. If there is a child involved, it is prudent to make sure the definitive section of the will expressly states what a parent is and what a child is in order to avoid any legal complications that may arise because of the manner in which parental rights are established.

Revocable Trust

Revocable trusts are often created as a complimentary document to wills. They are drafted for a variety of reasons, but they can be extremely beneficial for same-sex couples for two specific reasons. First, if made and funded during the settlor’s lifetime, the settlor of the trust can designate his/her partner as a co-trustee allowing the partner to manage and administer the couple’s assets that are placed in trust. This does not give ownership to the partner, but it gives them a certain amount of control over the property. Second, a revocable trust does not have to go through the probate process so it never becomes a public document.

32 Opposite sex couples can own realty in the form of Tenancy by Entirety. This form is virtually the same as JTWROS except that there is no unilateral severance, which allows a certain amount of protection from creditors. Massachusetts allows same-sex spouses to own property on the same basis for opposite sex couples. Hawaii, Oregon, and Vermont authorize tenancy by entirety for registered partners.

33 See I.R.C. §2040. Internal Revenue Code section 2040 states that 100% of the fair market value of the property will be included in the estate of the first to die unless the surviving joint tenant can prove original contribution to the acquisition of the property. This is not a burden that traditional married couples have to concern themselves.

34 If this method is the best for your estate plan, hire a valuation expert in to set the value of the gifted portion in order to establish a fractional share discount for gift tax purposes.

35 See I.R.C. §2523.
Planning for Same-Sex Couples, continued

The benefit of avoiding probate is twofold. It allows privacy of how the assets will be distributed as well as lessening the likelihood that family members will contest because revocable trusts are more difficult to successfully challenge. If there is a concern of hostile family members challenging the person’s wishes, he/she should consider reiterating beneficiary designations in his/her revocable trust even though they would normally not pass through the will.

Beneficiary Designations

It is always important to have the beneficiary designations on retirement assets, banks accounts, investment accounts and life insurance up to date. It is also beneficial to know what a company’s policies are for non-spouse beneficiaries because distribution policies may differ.36

Life Insurance

Life insurance can be an essential estate planning tool for same-sex spouses because under the current federal law same-sex spouses cannot receive Social Security survivor’s benefits or corporate pension survivor benefits.37 Having a life insurance policy protects the surviving spouse by providing them with an income substitution. This is particularly important where there is income or wealth disparity between spouses. Depending on the size of the estate, an irrevocable life insurance trust (ILIT) might be the best method of purchasing and holding a life insurance policy because it removes the policy from the spouse’s estate and transfers wealth in a tax-efficient manner.38

Gifting

If same-sex spouses have a large disparity in wealth, they should consider equalizing their estates through gifting. As opposed to a wealth transfer between opposite-sex couples which is done without complication, same-sex couples have a few obstacles to overcome. Lifetime gifting between opposite-sex couples is exempt from the federal gift tax.39 At death, opposite-sex couples can bequeath the other property free of federal estate tax because of the marital deduction.40 For federal generation-skipping tax purposes, opposite-sex couples are considered the same generation regardless of age difference.41 Pursuant to DOMA, none of these benefits apply to same-sex couples. One of the simplest methods of estate equalization is for the wealthier spouse to utilize his/her annual exclusion afforded by the Internal Revenue Code (IRC)’s section 2503(b) so as not to begin depleting that spouse’s lifetime unified credit.

The wealthier spouse could also create a credit shelter trust either during his/her lifetime or at death that would provide for the surviving spouse during his/her lifetime and then pass on to a designated beneficiary at the spouse’s death without being included in the surviving spouse’s estate. Chapter 14 of the Internal Revenue Code was added by Congress in 1989 in an attempt to reduce the use of various estate planning techniques that they view as abusive. One of these techniques was the Grantor Retained Income Trust (GRIT) which permits property to be transferred while incurring only a small gift tax consequence.42 Congress placed four major limitations on

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36 Some companies require “non-spouse” beneficiaries, spouse being defined by federal law, to take a lump-sum distribution. A solution for this problem could be for the surviving spouse to roll the retirement asset over into an IRA. The surviving spouse might have to begin taking periodic distributions at that time, rather than waiting until 70 ½, but it is less of a tax-burden than receiving a lump-sum distribution. See Individual Retirement Arrangements, I.R.S. Pub. No. 590, at 18 (2010).
37 See 42 U.S.C. § 416. This section defines what constitutes a widow. See also The Social Security Handbook § 402 for further explanation. “Under Federal law an individual whose claim for benefits is based on a State recognized same-sex marriage or having the same status as spouse for State inheritance purposes cannot meet the statutory gender-based definition of widow or widower of the worker, including one who is divorced.” Id.
38 See I.R.C. §2042. Internal Revenue Code section 2042 brings life insurance proceeds into a decedent’s taxable estate if the policy is owned by the decedent at his/her death.
39 See I.R.C. §2523.
40 See I.R.C. §2056.
41 See I.R.C. §2651(c).
42 GRITs have been replaced by new techniques called Grantor retain annuity trusts (GRATs) and grantor retained unitrusts (GRUTs) which are beneficial but not as tax efficient as a GRIT.
Planning for Same-Sex Couples, continued

GRITs. The major caveat to these restrictions is that they only apply to transfers that are to members of the grantor’s family. Because the federal government does not recognize same-sex couples as spouses, they are not restricted in the use of GRITs. This is one situation in which being a same-sex couple has an advantage. A GRIT is an irrevocable trust to which the grantor transfers property while retaining the right to whatever income that property produces for a specific period of time. When that period of time is over, the trust terminates and the property is distributed to a third party. The transfer of property to a GRIT is a taxable gift. The value of the gift is the value of property placed into the trust minus the actuarial value of the grantor’s reserved income interest. Since the remainder is a future interest and therefore does not qualify for the annual exclusion, the donor must use some unified credit. However, the longer the grantor’s income interest in the trust, the smaller the gift becomes. If the grantor keeps a contingent reversionary interest in the property, the taxable gift diminishes even further. If the grantor dies during the term of the GRIT, the entire principal must be included in the estate of the grantor. If the grantor did not create the GRIT, all of the property would be included in his/her estate. Therefore, the only downside is the administrative and legal fees that go along with establishing the GRIT.

A Qualified Personal Residence Trust (QPRT) is another good wealth transfer tool to consider for same-sex couples. A QPRT is a similar concept to the GRIT except that it transfers the ownership of a home to the other spouse’s rather than cash, marketable securities or business interests which would be transferred by a GRIT. Then instead of receiving the income from the trust, the grantor spouse receives the right to live or use the house rent free for a period of years. At the end of the term, if the grantor is still living in the house, then he/she must pay rent to the beneficiary spouse. If the grantor dies during the term of the trust, then the house will be included in the grantor’s estate for estate tax purposes.

Conclusion

As with planning for opposite-sex couples, there is not one plan or one transfer technique that works for all same-sex couples. Plans vary in response to the personalities of the couple, their life situation, where they live and the constantly changing laws. For these reasons, it is imperative to know the different regulations of the states for our clients. This will afford them the best planning in the event of death, medical emergency or other major life events.

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43 The four major limitations are: 1) only income producing property can be placed in GRITs; 2) the grantor must retain an income interest in either the form of an annuity or a predetermined value (unitrust); 3) if the actual income was less than the annuity or unitrust interest then trust principal must be distributed back to the grantor; 4) the value of the gift would be determined by subtracting the actuarial value of the annuity or unitrust interest from the value of the property transferred to the trust rather than reducing it by retaining a contingent reversionary interest. See I.R.C. §§2701-2704.
Wealth Transfer Planning Considerations for 2011 and 2012

The Tax Relief, Unemployment Insurance Authorization and Job Creation Act of 2010 (the “Act”) created significant changes in the area of wealth transfer planning. Most notably, the Act increased the federal estate, gift and GST tax exemption amount for years 2011 and 2012 and reduced the transfer tax rate.

- Estate Tax: The estate tax exemption amount increased to $5 million per individual (or $10 million per married couple), reduced by the amount of any lifetime taxable gifts made, indexed for inflation for 2012.

- Gift Tax: The estate and gift tax is also “reunified” meaning that the gift tax exemption is the same as the estate tax exemption – i.e., $5 million per individual (or $10 million per married couple), indexed for inflation for 2012.

- GST Tax: The GST tax exemption increased to $5 million per individual (or $10 million per married couple), indexed for inflation for 2012.

- Tax Rate: The estate, gift and GST tax rate is 35% for 2011 and 2012.

Without further Congressional action, beginning in 2013, the estate, gift and GST exemption amount will decrease to $1 million and the transfer tax rate will increase to a maximum rate of 55%. The combination of increased exemption amount, decreased tax rate, low interest rates, relatively low asset values and the lack of recent legislation thus far restricting the use of some popular wealth transfer strategies make this an opportune time for wealth transfer planning.

Review and Update Current Estate Planning Documents

Regularly reviewing and updating current estate planning documents, including life insurance and retirement account beneficiary designations, is critical. This is especially important after significant life events such as marriage, birth, divorce. A significant financial change would also warrant an estate plan review. In addition, given the recent legislative changes, this is an important time to reexamine your overall estate plan to ensure that your plan is current with existing law and is taking advantage of all new planning opportunities.

For example, reasons to review your plan include the fact that many estate plans rely on formula clauses that are tied to the estate and GST exemption to allocate assets among family members, most commonly between a spouse and other beneficiaries. As a result, beneficiaries may be entitled to different amounts as the estate and GST exemptions change. In addition, for states such as New York that impose a separate estate tax, the change in the federal estate tax exemption amount may have an inadvertent effect on state estate tax.

Wealth Transfer Planning Opportunities

Lifetime Gifting

In 2011 and 2012, the lifetime gift tax exemption increased to $5 million per individual (or $10 million per married couple). This means that an individual who has not utilized his or her lifetime gift tax exemption may now gift up to $5 million (or $10 million per married couple) without incurring federal gift tax. An individual who has previously used his or her $1 million lifetime gift tax exemption now has the opportunity to make an additional gift of $4 million (or $8 million per married couple) without incurring federal gift tax. Additionally, the top gift tax rate has been reduced from 55% to 35%.

There are significant tax advantages to lifetime gifting. First, the asset gifted could be removed

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2 The GST tax exemption will be indexed for inflation and will likely be approximately $1.4M in 2013.

3 Note that a small number of states impose a separate gift tax and the exemption amount may be lower than the federal exemption. Individuals should check with their counsel regarding their particular state gift, inheritance and estate tax rules.
Wealth Transfer Planning Considerations, continued

from the donor’s estate. Second, any future income and appreciation associated with the gifted asset could also be removed from the donor’s estate. Third, due to the nature of how the estate and gift tax are calculated, the gift tax is generally more efficient from a tax perspective. For example, a client who wishes to make a lifetime gift of $1 million to his or her children would need to have $1,350,000 to do so ($1 million gift and a federal gift tax of $350,000). In contrast, a client who bequeaths $1 million at death to his or her children would need approximately $1,538,475 to do so ($1 million bequest and a federal estate tax of approximately $538,475). The reason for this disparity is because the gift tax is tax-exclusive, meaning that it is calculated exclusive of the gift tax owed. The estate tax, on the other hand, is tax-inclusive, meaning that it is calculated inclusive of the estate tax owed. In other words, there is an estate tax imposed on the amount of estate tax to be paid. In addition, the use of lifetime gifts may also save state transfer taxes because many states such as New York impose a separate estate tax but not a separate gift tax.

Lifetime Gifting to Grandchildren

The GST tax is a tax that is imposed on transfers to grandchildren or younger generation (or trusts for their benefit). This is a separate tax in addition to the estate and gift tax. In 2011 and 2012, the GST exemption increased to $5 million per individual (or $10 million per married couple). Therefore, a grandparent may wish to consider making gifts to grandchildren, whether outright or in a GST trust, to take advantage of the increased exemption. In a properly structured GST trust, assets held in the trust and any future income and appreciation could effectively be shielded from future estate or GST tax. In certain jurisdictions, this type of generation-skipping trust can continue in perpetuity (the so-called “Dynasty Trust”), thereby potentially extending the tax benefits for generations to come.

Sale to an Intentionally Defective Grantor Trust

One effective strategy to leverage the increased gift and GST exemption amount is the use of a sale to an intentionally defective grantor trust (“IDGT”). Due to the nature of this structure, the IDGT is also the strategy of choice for GST planning.

In this strategy, the grantor creates an irrevocable trust and funds the trust with a gift typically of cash. The size of the gift is often determined by the size of the transaction. The trust then purchases an asset with high growth potential from the grantor in exchange for an installment note. The note must include an interest rate equal to at least the monthly Applicable Federal Rate (“AFR”) in effect at the time of funding. If the trust assets grow beyond the AFR, then the excess appreciation could pass to the beneficiaries of the trust without further transfer tax. For additional leverage, the grantor could sell assets which qualify for a valuation discount (e.g., interests in a family limited partnership). If the grantor dies during the term of the note, then the fair market value of the note (to the extent the loan has not been repaid) is included in the grantor’s estate. That value may sometimes be less than the outstanding principal depending on several factors.

The IDGT is considered a grantor trust for income tax purposes. Therefore, the grantor does not recognize gain or loss on the sale of assets to the IDGT. The grantor is also not taxed on the annual interest payments received from the note. In addition, the grantor is obligated to pay the income tax on the income attributed to the trust, thereby allowing the assets in the trust to more effectively grow for the benefit of the beneficiaries.

Because current AFRs are low (e.g., mid term AFR for March 2011 is 2.44%), it may be possible to shift substantial appreciation to beneficiaries at relatively low transfer tax cost. The increased lifetime gift and GST tax exemptions also allow for more assets to be sold without incurring an immediate gift tax. In addition, if assets sold can be discounted (i.e., through lack of marketability, fractional interest, control, etc.), additional wealth may be transferred to beneficiaries.

The Obama Administration Fiscal Year 2012 Revenue Proposals include a provision that would limit the availability of these type of valuation discounts.

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Wealth Transfer Planning Considerations, continued

Qualified Personal Residence Trust

Transferring a personal residence to a Qualified Personal Residence Trust (“QPRT”) is a popular estate planning strategy that may help reduce the size of your estate. The increased lifetime gift tax exemption and relatively low value of homes make QPRTs a popular strategy.

This strategy consists of a gift of a personal residence to an irrevocable trust. The grantor would retain the exclusive right to use and occupy the personal residence for a period of years. This retained right creates a discount on the value of the home for gift tax purposes. At the expiration of the trust term, the property in the trust would pass to the beneficiaries. The grantor could continue to live in the residence at that time with the beneficiaries’ consent and payment of fair market rent.

An essential element to consider is the length of the term of the QPRT. This is because the grantor must survive the term of the QPRT in order for this strategy to work. If the grantor dies during the QPRT term, the value of the home is includable in the grantor’s estate and the estate planning benefits of the QPRT have not been achieved.

Additionally, the transfer of fractional interests in a residence could be used to hedge against the possibility of premature death. For example, a grantor may create three QPRTs with terms of 5, 10 and 15 years. The grantor transfers a 1/3 interest in the residence to each of the trusts and if the grantor dies in year 12, only 1/3 of the interest is included in grantor’s estate. Another possibility is for a married couple to create two QPRTs, each with his or her 50% interest in the property. If one spouse dies during the term of the QPRT, then the other 50% interest in the home belonging to the surviving spouse’s QPRT could still be successful. In certain cases, a valuation discount may be possible due to the fractional interests involved.

During the term of the trust, the grantor is still considered the owner for income tax purposes and could receive the benefit of any income tax deductions related to the property. During this time, the grantor also receives the tax benefits associated with the sale of a principal residence.

A QPRT could be an effective strategy for individuals to transfer valuable residences to the next generation. Depressed real estate values and increased lifetime gift tax exemption could permit the transfer of potentially large amounts of wealth and future growth related to a residence to the beneficiaries at a reduced gift tax cost.

Grantor Retained Annuity Trust

Another attractive planning strategy in the current low interest rate environment is a Grantor Retained Annuity Trust (“GRAT”). Last year, several bills were introduced in Congress to restrict the use of GRATs. However, the Act did not contain any of these provisions and GRATs remain a popular estate planning strategy.

A GRAT is an irrevocable trust to which a portion of the grantor’s property is transferred to the trust with the grantor retaining the right to receive a fixed payout, or annuity, each year for the term of the trust. The GRAT must pay the required annuity each year regardless of the amount of income actually generated by the trust assets. If the trust assets do not generate sufficient income to fund the annuity amount, the trust principal must be utilized to make up any deficiency. When the trust terminates, the assets remaining in the trust pass to the beneficiaries (or a trust for their benefit) without the imposition of any additional transfer tax. However, if the grantor dies before the end of the trust term, a portion or all of the trust assets will be included in the grantor’s estate for estate tax purposes.

Upon the creation of the GRAT, the grantor is deemed to have made a gift equal to the present value of the assets that will pass to the beneficiaries at the end of the trust term. A GRAT is usually structured to set the annual annuity sufficiently high so that the value of the remainder interest (the value of the gift) is as close to zero as possible. The value of the annuity stream typically equals the value of the assets in the GRAT plus an imputed interest rate (the “§7520 rate”) - a rate that varies monthly, and remains in effect for the term of the GRAT once established.

The GRAT allows the transfer of appreciation in excess of the §7520 rate to pass to the beneficiaries without additional transfer tax. If the assets do not appreciate, all of the assets would have been returned to the grantor by the end of the GRAT term without adverse tax
Wealth Transfer Planning Considerations, continued

consequences. From an income tax perspective, all income tax liability incurred by the GRAT during its term is attributed to the grantor.

Assets that have significant potential for appreciation are ideal for GRATs. Because the current §7520 rate is low (e.g., 3% in March 2011), a GRAT may shift significant amount of wealth to beneficiaries at little or no transfer tax cost.

Charitable Lead Trust

For individuals who are charitably inclined, this is an ideal time to consider establishing a charitable lead trust (“CLT”). A CLT is an attractive option during the current low interest rate environment that could help optimize the increased lifetime gift tax exemption by gifting to family members and charity at the same time.

A CLT permits an individual to donate the income stream from an asset to one or more charities for a set number of years or for one or more person’s lifetime. The remaining assets of the trust, at the end of the trust term, pass to the beneficiaries (or a trust for their benefit). There are different ways to set up a CLT, either grantor or nongrantor, depending on one’s goals and objectives. A grantor CLT permits the grantor an immediate income tax deduction at the time the CLT is established. However, during the term of the CLT, the grantor would be responsible for the income tax liability of the trust. A nongrantor CLT, on the other hand, does not allow the grantor to receive an immediate income tax deduction. However, during the term of the trust, the trust would receive an income tax deduction for the income stream paid to charity.

A CLT allows the transfer of appreciation in excess of the §7520 rate to pass to the beneficiaries. Because current §7520 rates are low, this makes CLTs an attractive strategy for those who want to benefit family members and charities. If structured as a grantor CLT, the individual could also receive an immediate income tax benefit, which could be beneficial in a high income earning year.

Intrafamily Loan

The current low interest rate environment is an ideal time to consider loans between family members. For example, a parent may wish to lend money to a child (or a trust for the child’s benefit). The parent must charge a minimum interest rate based on the appropriate AFR. The child can then use the borrowed money to invest for a higher return (or pay off other debt with a higher interest rate). This strategy will generally be successful if the investment returns more than the interest being charged on the note.

For individuals with existing intrafamily loans, this may be a good time to consider “refinancing” using the current lower interest rates. Others may wish to take advantage of the increased lifetime gift tax exemption and forgive any existing intrafamily loans (a forgiveness of loan is deemed a gift to the debtor).

Note Regarding Gifts in 2011 and 2012

Commentators have suggested that there may be a possibility that there will be a “clawback” of the prior tax benefit. The reason for this uncertainty is based on how the estate tax is computed. In essence, the estate tax takes into account the amount of any post-1976 taxable gifts and adds it back to the taxable estate. The gift tax previously paid is then backed out of the computation. Individuals who make lifetime gifts in 2011 and 2012 should be aware that because of the potential disparity in the estate, gift and GST exemption rates in 2013 and beyond (i.e., if the exemption decreases to $1 million or another amount), there is some uncertainty as to how prior gifts may be treated.

However, even assuming a clawback applies, donors who elect to use their $5 million gift (and GST) tax exemptions in 2011 and 2012 should be no worse off than those who die without having made those gifts. In fact, there may be benefits to using the $5 million exemption in 2011 and 2012. The appreciation on the gifted assets will unlikely be subject to the “clawback,” even if the gifts themselves are. Also, leveraging the gifts through some of the vehicles discussed above could enable donors to transfer appreciation on assets in excess of the $5 million exemption.

Conclusion

Even if additional gifting is not in your current plans, in light of recent changes in legislation, it is critical to review your current estate plan to ensure that it is consistent with existing law and your current wishes. In addition, the increased estate, gift and GST exemption amounts and decreased tax rate in 2011 and 2012 may create an opportunity for significant wealth transfer. For more information please contact your regional Wealth Strategist to learn how our Wealth Planning Group can assist you.

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Wealth Transfer Planning Considerations, continued

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Case Summaries from the Orphans’ Court Litigation Committee

Tax Concerns With Modification Under the Uniform Trust Act

By TIMOTHY J. HOLMAN, ESQUIRE AND BRADLEY D. TEREBELO, ESQUIRE HECKSCHER, TEILLON, TERRILL & SAGER, P.C.

The passage of the Pennsylvania Uniform Trust Act (20 Pa. C.S. §§ 7701-7799.3) has made it significantly easier to modify Pennsylvania noncharitable irrevocable trusts. See, e.g., 20 Pa. C.S. §§ 7710.1 & 7740.1-7740.8. Modifying a trust can, in the appropriate case, allow parties to avoid litigation, and fiduciary litigators should consider whether their clients can achieve their goals via trust modification rather than litigation where possible. However, modifying a trust could have significant, and unintended, negative tax consequences for the settlor(s) and beneficiaries of such trusts. The following is a brief (and by no means comprehensive) overview of certain generation-skipping transfer (“GST”) tax, estate tax, gift tax and income tax considerations that a practitioner should make before undertaking any modification of an irrevocable trust to avoid any such unintended tax consequences.

GST TAX

The IRS issued a series of regulations discussing when a modification of a grandfathered GST tax exempt trust (that is, it was irrevocable on or before September 25, 1985) could lose its GST tax exempt status. See Reg. §26.2601-1(b)(4). For example, if the modification of a grandfathered GST tax exempt trust shifts a beneficial interest in a trust to any beneficiary that occupied a lower generation than the persons who already held a beneficial interest prior to the modification, or if the modification extends the time for vesting any beneficial interest in the trust, the trust could lose its grandfathered GST tax exempt status.

However, it is not clear whether a division or modification of a trust that would cause a grandfathered GST tax exempt trust to lose its GST tax exempt status would also cause a trust that is GST exempt because of the application of the GST tax exemption to lose its GST tax exempt status. The IRS has stated that, “at a minimum,” if a modification would not cause a grandfathered GST tax exempt trust to lose its GST tax exempt status, such modification would not cause a trust that is GST tax exempt by reason of the application of the GST tax exemption to lose its GST tax exempt status. See, e.g., PLRs 200822008, 200919008, 200919009 and 200919010.

ESTATE TAX

There is concern that a settlor’s consenting to modify an irrevocable trust could cause the trust’s assets to be included in the settlor’s estate for federal estate tax purposes under IRC §§ 2038 or 2036.

In PLRs 200919008, 200919009 and 200919010, the IRS concluded that modification of an irrevocable trust did not implicate IRC §2038 (which includes in a decedent’s taxable estate property which is subject to alteration, amendment, revocation or termination by the decedent). The IRS relied on Reg. §20.2038-1(a)(2), which provides that IRC §2038 does not apply “if the decedent’s power [to revoke or amend the trust] could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of parties under local law.” Because the modifications were permitted under the state’s version of UTC §411(a), and all parties consented to the modification, the IRS concluded that IRC §2038 did not apply.

There appears to be no guidance, however, as to whether a continued on Page 20
settlor’s consenting to modify a trust
could implicate IRC §2036. IRC
§2036 (which includes in a deces-
dent’s taxable estate property which
the decedent may affect “(1) the pos-
session or enjoyment of, or the right
to the income from, the property, or
(2) the right, either alone or in con-
junction with any person, to designate
the persons who shall possess or enjoy
the property or the income therefrom.” IRC §2036(a) (emphasis
added).

To avoid the possible estate
tax inclusion of a trust in the settlor’s
estate under IRC §2036, consider-
ation should be made as to whether
or not the trust should be modified
under 20 Pa. C.S. §7710.1 (with-
out the settlor’s consent but with
the consent of all beneficiaries and
trustees), even if the settlor is alive
to avoid having the settlor consent to
any modification.

GIFT TAX

If a beneficiary of a trust
gives up or reduces a right to income
or principal of the trust by consent-
ing to a modification, that beneficia-
ry could be making a gift to the other
beneficiaries of the trust. However,
valuing any such “gifts” will often
be difficult, if not impossible.

PLR 200917004 concerned
dispositive GST exemptions to a grand-
fathered GST exempt irrevocable
trust where the settlor was deceased
(it is unclear whether the state was a
UTC jurisdiction). The trust specifi-
cally excluded adopted issue from
the term, “issue,” and the trustee pe-
tioned the court, with the consent of
the beneficiaries, to modify the
trust to include individuals legally
adopted by settlor’s issue by blood
in the trust’s definition of “issue.”
The court granted the requested mod-
ification. The IRS concluded that
by consenting to the modification to
expand the definition of “issue,” the
issue related to the settlor by blood
who were beneficiaries of the trust
were reducing the amount of income
and/or principal they could receive
and therefore made a taxable gift to
the adopted issue who were now ben-
eficiaries pursuant to IRC §2501.

INCOME TAX

It is possible that a benefici-
iary’s consenting to modify a trust
could result in taxable gain to the
beneficiary if the modification mate-
rially changes the beneficiary’s inter-
est, as discussed in PLR 200231011.
In PLR 200231011, a trust was cre-
ated for the life of the decedent’s
grandson. The trust provided that
grandson’s interest to receive an annuity
and the remainder was to be paid to
charity. The trust was amended to
provide that the grandson would re-
ceive annual distributions determined
in accordance with a “Performance
Chart,” subject to a floor and a ceil-
ing.

Following disputes between
the income beneficiary and the chari-
table remainder beneficiaries, all ben-
eficiaries entered into an agreement
whereby they agreed that the trustees
would make an immediate distribu-
tion of the remainder interest to the
charities and to leave the rest of the
assets in trust for the grandson’s life-
time, during which time he would
receive a 7% unitrust interest (the
“Settlement”). They also agreed to
submit the agreement to the court for
approval.

The IRS found that the Set-
tlement resulted in taxable gain to
the grandson. Under the terms of the
trust as modified (prior to termina-
tion pursuant to the settlement agree-
ment), the grandson was entitled to
trust income, subject to a floor and
a ceiling. Under the Settlement, he
became entitled to annual payments
of a unitrust interest in the trust. The
grandson therefore lost the protec-
tion of the guaranteed minimum
annual payments pursuant to the
first modification as required by the
Performance Chart, and payments
would be determined without regard
to trust income. In short, the grand-
son’s interest in the modified trust
would entail legal entitlements dif-
ferent from those he currently pos-
sessed.

Pursuant to IRC §1001(c)
(1), the portion of the adjusted unio-
form basis assigned to the grand-
son’s interest in Trust was disregarded.
Accordingly, for purposes of
the modification “transaction,” the
grandson had no basis in his interest
in the trust. Therefore, the amount
of gain Grandson realized under
§1001(c) was the amount Grandson
realized from the disposition of his
assets in the trust. The gain realized
by Grandson from the disposition of
his interest is long term capital gain.
See Rev. Rul. 72-243, 1972-1 C.B.
333, providing that a sale of an in-
come interest in a trust is a sale of a
capital asset within the meaning of
§§ 1221 and 1222.

CONCLUSION

As can be seen from the
above examples, practitioners
should take care to ensure that modi-
fications they seek pursuant to the
Pennsylvania Uniform Trust Act
will not cause unintended nega-
tive GST, estate, gift or income tax
consequences to the settlor(s) and/
or beneficiaries of a trust. Fixing
one problem by modification could
cause a whole host of tax problems
that may not be as easily remedied.
Whether to E-file Certificates of Service and “Green Cards”

By BERNICE J. KOPLIN AND KAREN CONN MAVROS, ESQUIRES

Most attorneys now feel comfortable e-filing their pleadings as part of Orphans’ Court practice. A frequent question, however, is whether to e-file Certificates or Affidavits of Service and the Certified Mail “green cards” prior to a Hearing or Audit, or to hand them up at the Audit or appearance. A review of the Pennsylvania Orphans’ Court Rules and the “Orphans’ Court Electronic Filing System User Manual” does not clarify or address this issue.

In informal discussions with Judge O’Keefe’s and Judge Herron’s law clerks, it became apparent that these Judges have no preference regarding whether they are e-filed prior to the attorney’s appearance in court. However, they require that the attorney bring the original Certificate of Service and green cards, as appropriate, to court, to hand up to the Judge so that the Judge can accurately read them into the record, especially in Guardianship matters. If these documents were not e-filed prior to the attorney’s appearance, then after the hearing they will be scanned by the Clerk and entered on the docket. Their law clerks have advised that it is a good practice to check the dockets after a few days to confirm that the entries have been made on the docket. E-filing by the attorney would eliminate this necessity to check the docket several days after the proceeding. Judge Carrafello’s law clerk has advised that His Honor prefers that such Certificates or Affidavits be filed prior to appearing in court and that the originals be presented in court.

Readers are encouraged to send their questions or ideas for consideration in future columns to Bernice J. Koplin at bjkoplin@sglk.com.
Should an estate planning lawyer send the client an exit or closing letter to formally terminate the lawyer-client relationship after the lawyer completes the estate planning assignment?

There is certainly no requirement that a letter formally terminating the relationship be sent to an estate planning client, and practitioners are sometimes reluctant to send such letters fearing they may be misinterpreted by the client. However, the lawyer is well-advised to do so if the only contact with the firm is the estate planning assignment and if the lawyer is with a firm of any size. This is particularly true if the law firm has agreed to retain the estate planning documents and has a practice of sending periodic newsletters for marketing purposes to their clients.

The concern is that the failure to send a termination letter could result in subsequent embarrassing conflict of interest situations and even malpractice actions based on an alleged failure of the firm to keep the estate planning client informed of changes in the law applicable to estate planning.

Such concerns are not far-fetched. First, because the determination of the existence of a lawyer-client relationship is based primarily on the reasonable subjective belief of the client, it has been held that a “lawyer-client relationship does not terminate easily” and that “something consistent with the termination of the relationship must transpire in order to end the relationship.” See Jones v. Rabanco, Ltd., 439 F. Supp. 2d 1149 (W.D. Wash. 2006) and SWS Financial Fund A v. Solomon Bros., Inc., 790 F. Supp. 1392 (N.D. Ill. 1992). The Jones case held that a three year communications gap is not sufficient to end a lawyer-client relationship.

The Commentaries by The American College of Trust and Estate Counsel on the Rules of Professional Conduct, specifically with respect to Rule 1.4, are instructive. They provide that the end of the estate planning assignment does not necessarily end the lawyer-client relationship. The ACTEC Commentary says that it merely initiates a “dormant” representation, subject to activation by the client unless the lawyer or client has formally terminated the relationship. Of course, one would expect this result if the client has other matters with the lawyer or his or her firm. However, practitioners are surprised to learn that the mere completion of the assignment is usually not deemed enough to terminate the lawyer-client relationship.

Imagine the hundreds, or even thousands of existing “dormant” clients who are, figuratively speaking, sleeping in the Will safes of medium to large sized law firms, the vast majority of whom are connected to the firm solely because of the preparation and retention of a simple Will. Consequently, if the firm wishes to undertake the representation of a party whose interests are adverse to the estate planning client, the firm is faced with determining whether it may proceed based on a Rule 1.7 (Conflict of Interest: Current Clients) analysis, which is a much tougher standard than Rule 1.9 (Duties to Former Clients). Furthermore, though not as likely, the client could complain, or his or her estate and beneficiaries could complain, that the law firm had a duty to advise the client of the need to change the estate planning documents as a result of recent changes in the tax laws.

Also, Comment 4 to Rule 1.3 (Diligence) says “Doubt about whether a client-lawyer relationship still exists should be clarified by the lawyer, preferably in writing, so that the client will not mistakenly suppose the lawyer is looking after the client’s affairs when the lawyer has ceased to do so.” Thus, even if the engagement letter limits the scope of the engagement to the estate planning assignment, a termination letter should still be sent particularly if the lawyer agrees to retain the documents for the client.

Accordingly, it would seem wise, at minimum, to send the client a letter after the completion of the estate planning assignment advising that, because it is impractical to do so, the firm cannot undertake the responsibility of keeping the client informed of changes in the law. Even better, the lawyer could

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make it clear in a well-crafted and more comprehensive letter addressed to the estate planning client that the relationship has been formally terminated. Rule 1.16 certainly permits the lawyer’s termination of a lawyer-client relationship.

The “exit,” “closing” or “termination” letter, which must be diplomatic, might say something like the following: “Now that the estate planning assignment has been completed, our representation of you will be concluded for all purposes, unless arrangements for continuing the representation are made. We will be pleased to provide additional or continuing services, but unless arrangements for such are specifically made, we will have no further responsibility to you in connection with any future or continuing issues pertaining to your estate planning, including a duty to notify you of any changes in the law or the necessity to make any changes in your estate planning documents.”

In summary, lawyers in mid to large sized firms who represent a client solely for estate planning services may find it wise to send an effective closing letter. However, it should be expressed in a manner that does not leave the client with the impression the lawyer is not interested in representing the client in the future.

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1617 JFK Boulevard
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19th Floor
Philadelphia, PA 19103
TRANSFER TAX UPDATE

By MARGERY J. SCHNEIDER, ESQ., LLM (Tax)
STERN AND EISENBERG, LLP

I. FEDERAL ESTATE TAX

ESTATE INCLUSION

Van v. Commissioner, T.C. Memo 2011-22 (January 27, 2011)

At stake in this case is whether the value of the house in which a decedent lived and to which she held title is includible in her estate. The IRS argued that the decedent, Adelina Van, retained possession or enjoyment of the house at her death, even though title to it “duck[ed] and weav[ed]” as it passed gratuitously to various members of her family, ending up as agent for her daughter and son-in-law created a resulting trust, reasoning that in the case of a parent-child relationship a gift, and not agency, is assumed.

Estate of Riese v. Commissioner, T.C. Memo. 2011-60 (March 15, 2011)

The Tax Court held that, although the term of a qualified personal residence trust (QPRT) had ended six months before her death and decedent had failed to pay rent during that period, the value of a decedent’s residence was not includible for estate tax purposes in her gross estate. The decedent, Sylvia Riese, a New York resident, established a three-year QPRT in 2000 and executed a deed transferring her residence to the QPRT. She filed a gift tax return and paid gift taxes on the value of the residence discounted by the value of her retained term. The QPRT agreement stated that if Mrs. Riese survived the term of the QPRT, the QPRT would terminate and its balance (i.e., the residue) would be distributed in equal shares to two trusts. It was explained to Mrs. Riese and her daughter, Mrs. Grimes, who handled Decedent’s financial matters and served as co-attorney-in-fact for her mother, that Mrs. Grimes would pay rent to the two trusts if she continued to live in the residence after the termination of the QPRT. The QPRT terminated on April 19, 2003, but no deeds transferring the property to the two trusts were executed. At its termination, Mrs. Grimes made inquiries to the family’s estate planning attorney concerning the proper amount of rent to be paid to the two trusts, and the attorney advised that the rent would be determined by the end of that year. Decedent died unexpectedly on October 26, 2003. She had not paid any rent between the date of the termination of the QPRT and her date of death; however, she had paid all property taxes, insurance, upkeep and maintenance for the residence.

The Estate of Sylvia Riese filed Form 706 in January, 2005, claiming a deduction under IRC Section 2053 for the fair market rent of $7,500 per month from the date of termination of the QPRT until Mrs. Riese’s death. It also claimed a deduction for the fair market value of post-death rent from Mrs. Riese’s date of death for administration expenses. The value of the residence was not included in the calculation of her gross estate. The IRS determined that the residence should be includible in Mrs. Riese’s gross estate at its full fair market value of $6.1 million and the deductions for pre- and post-death rent should be denied. It argued that the date-of-death value of the residence was includible in the gross estate under IRC Section 2036(a) because of an implied agreement that Mrs. Riese would retain an interest in the residence for life.

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The Tax Court held that no such implied agreement existed. It stated that the facts of the case indicate that an express agreement among the parties for Mrs. Riese to pay fair market rent in fact existed, that Mrs. Riese intended to pay such rent, and that the payment of rent by the end of the calendar in which the QPRT terminated would have been reasonable. The value of the residence was therefore properly excluded from the gross estate. The Court also held that the estate was entitled to a Section 2053 deduction for accrued rent during Mrs. Riese’s lifetime because, under New York law, Mrs. Riese’s continued occupation of the residence constituted a tenancy-at-will. However, Court denied the deduction for post-death rent because, in the absence of a formal lease, the tenancy-at-will ceased at Mrs. Riese’s death.

VALUATION


The issue in this case is the valuation for federal estate tax purposes of a 1,100 acre California ranch which the decedent had transferred in equal shares to his children while reserving a life estate for himself. The estate attempted to apply a 48% combined discount for lack of marketability and lack of control, but the IRS argued that the value includible in the estate should be the undiscounted value of the entire fee simple interest. The Tax Court found that no discount should be applied.

The decedent, who died in 2004, had gratuitously transferred undivided one-fifth interests in the property to each of his five children as tenants in common in 1965. However, he retained a life estate, lived on the property and paid all upkeep and expenses.

The Court included the full fair market value of the property in the taxable estate, reasoning that the transfer of the property was essentially testamentary in nature under IRC Section 2036(a)(1) because the decedent had possession and enjoyment of the property during his lifetime and controlled its disposition at his death. The transfer of ownership and separation of interests in the property was deemed to occur at decedent’s death, not before.

ESTATE TAX DEDUCTIONS

Estate of Shapiro v. U.S. (9th Cir, February 22, 2011)

In a 2-1 decision, the Ninth Circuit Court of Appeals reversed the decision of the U.S. District Court for the District of Nevada, holding that the lower court’s denial of the plaintiff’s request for an estate tax refund was based on a misunderstanding of Nevada law concerning contracts between cohabiting people. The Court of Appeals ruled that an estate can deduct the amount paid in settlement of a palimony claim under IRC § 2053.

Bernard Shapiro and Cora Chenchark lived together for twenty-two years but never married. During that time, Chenchark provided homemaking services. When they split up in 2009, Chenchark filed suit against Shapiro in state court, claiming breach of express and implied contract, breach of fiduciary duty and quantum meruit. She stated that she and Shapiro had orally agreed to pool their assets. Shapiro died while the suit was pending. The jury found for Shapiro’s estate, and Chenchark appealed. While the appeal was pending, a settlement was of $1M was reached between the parties.

The Estate paid over $10M in estate and GST taxes but claimed a refund of $5M on the grounds that Chenchark’s claims decreased the value of the estate.

Relying on the precedent provided by earlier state court palimony cases, the Court held that the homemaking services can constitute sufficient consideration to support a contract under state law, either express or implied, for a nonmarital cohabitation agreement. It ruled that as long as the parties’ conduct makes their intention clear to form a contract concerning their property, it does not matter that each party brings different services to the relationship. The Estate, once it quantified the value of Chenmark’s household services, was entitled to take an estate tax deduction for that amount.

In a strong dissent, Judge Tashima focused on the estate tax issues in the case, specifically that under IRC Section 2053, deductions based on promises or agreements must be supported by full consideration in money’s worth. He concluded that “any love and affection provided to Shapiro by Chenchark must not, and cannot, be treated as consideration for purposes of § 2053, even if it would support a contract under state law. ‘Nevada law regarding contracts between cohabiting individuals’ ... is simply irrelevant to determining the adequacy of consideration under § 2053.’”

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A federal district court in Pennsylvania held that a $12 million settlement payment made by an estate to a charity qualified for a charitable deduction under IRC Section 2055, even though the charity was not named as a remainder beneficiary in the final version of decedent’s will.

The A.J. and Sigismunda Palumbo Charitable Trust, established in 1974, was named as a beneficiary of Antonio J. Palumbo’s residuary estate in several paragraphs throughout Mr. Palumbo’s last Will, executed in 1999, and several codicils. But at his death in 2002, it was discovered that, due to a scrivener’s error to which the drafting attorney admitted, there was no express residuary provision in the 1999 Will or any of the three codicils. The decedent’s son concluded that, due to the lack of the residuary distribution provision, he was the sole intestate heir and was entitled to the entire residue of the estate. However, the trustee of the Charitable Trust claimed that the testator intended to disinherit the Charitable Trust.

The estate filed a claim for a federal estate tax charitable deduction for the portion of the residue paid to the Charitable Trust. The IRS rejected the deduction because the gift was not pursuant to a settlement agreement and not pursuant to the dispositive terms of the Will. In response the estate filed a claim in district court.

The Court defined the issue to be decided as whether the sum of $11.7 million qualified as a charitable deduction under IRC §2055 and therefore was not part of the gross estate subject to federal income taxation. It ruled that the legislative history of IRC §2055 indicated that the intent of the statute was to encourage charitable gifts. The court held that the Charitable Trust had an enforceable legal right based on the unrefuted evidence provided by prior documents that Mr. Palumbo intended in his 1999 Will to give the residuary estate to the Charitable Trust. In thus ruling, the Court cited Pennsylvania case law establishing that the intent of the testator should be followed to avoid the creation of an intestate estate, making it desirable to go beyond the “four corners” of the will to ascertain the testator’s intent. The Court concluded that there was no evidence that Mr. Palumbo had intended to disinherit the Charitable Trust.

The Court contrasted the settlement in this case with that of Bach v. McGinnes, 333 F.2d 979 (3rd Cir. 1964), where the federal estate tax charitable deduction was disallowed because there was no bona fide legal dispute over the legal entitlement of the charity. In Bach, the parties simply reached an agreement that suited their economic interests.

ESTATE TAX COLLECTION


This case concerns the timeliness of an IRS action to recover estate taxes. The District Court denied the defendants’ motion to dismiss, which was based on their assertion that the government’s action was untimely based on the ten-year statute of limitations under IRC Section 6324(a)(1), the automatic special lien on the estate for non-payment of estate taxes. The IRS’s action, however, relied on IRC Section 6324(a)(2) to collect the unpaid estate taxes.

The defendants, the surviving daughters of Robert Q. Roth, Sr., were the beneficiaries of their father’s estate, which included stock in a small business. Their father died in 1991.

In March, 1992, the estate filed an IRC Section 6166 election with the original estate tax return in order to defer the payment of estate taxes over ten years. The closely held business that qualified for the Section 6166 deferral was sold in March, 1999 and the proceeds were transferred to the daughters. Under IRC Section 6166(g)(1)(A), the Section 6166 election terminated on the same day as the sale of the assets and the balance of the tax became payable upon notice and demand. In 2008, the IRS filed an action against the transferees to collect the balance due under IRC Section 6324(a)(2), which provides the following: “If the estate tax…is not paid when due, then the…transferee or beneficiary…who receives…property included in the gross estate…to the extent of the value, at the time of the decedent’s death, of such property, shall be personally liable for such tax.”

Decedent’s daughters filed a motion to dismiss the IRS action, which the District Court denied. The defendants appealed. The U.S. Court of Appeals held that the Government’s claim was timely under IRC Section 6324(a)(2) and affirmed the District Court’s decision.
Transfer Tax Update, continued

miss under IRC Section 6324(a)(1), which provides that the duration of the special lien for estate tax on the assets of an estate is a fixed 10-year period from the date of decedent’s death. They argued that the action was time-barred because it was begun more than 10 years after the decedent’s date of death. However, the court ruled that the 10-year statute of limitations began on the date of the sale of the assets, because the tax assessments against the transferees had been suspended as long as the Section 6166 election was in effect. Once the Section 6166 election terminated, the period for assessing the tax began. The action was therefore timely.


The Tax Court sustained the proposed collection actions of the IRS in this case. After granting the estate six annual §6161 extensions to pay its estate tax for reasons of hardship, the IRS granted a seventh extension in 2004, but only until December of that year. The IRS was concerned that the ten-year statute of limitations under §6324(a)(1) would prevent it from collecting the liability in full. It announced that it would begin making transferee assessments against the heirs of the estate who had received distributions from the estate but had not paid the estate tax and interest owed on their portion. When the estate did not meet the final deadline, the IRS sent a notice of intent to levy, which the estate appealed, claiming that the time for making a transferee assessment under §6309 had expired. The Court held that the levy did not constitute an abuse of discretion.

The estate offered the $700,000 in remaining estate assets as an offer-in-compromise. The IRS rejected this offer as inadequate, deeming that $3 million would be a reasonable amount to collect because the beneficiaries received over $3.4 million in IRA distributions. The court agreed.

_Baccei v. U.S._ (9th Cir. Feb 16, 2011)

The U.S. Court of Appeals for the Ninth Circuit affirmed the district court’s grant of summary judgment in favor of the IRS and ruled that a trustee of a revocable trust cannot avoid the penalties and interest assessed by the IRS for late payment of estate tax.

In 2006, the accountant hired by Ronald Baccei, executor of the estate of Eda O. Pucci and trustee of her revocable trust, failed to fully complete IRS Form 4768, requesting an extension of time to pay the estate tax. The estate lacked adequate liquid funds to pay the tax. The accountant did not enter an extension period in the field labeled “Extension Date Requested.” Instead of completing Part III, which sets for the reasons for the request for an extension, the accountant attached a statement explaining that the requested delay was due to ongoing litigation. In Part IV of the Form, the accountant estimated the estate tax payable at $131,327 and left blank the field labeled “Amount of Cash Shortage.”

The IRS determined that the request was not properly made and assessed late payment penalties of $58,000 and interest of $69,000. In addition, the IRS calculated the actual tax as $1,684,408.

The Court rejected all three of the estate’s arguments, as follows: 1) The estate argued that, by filing the partially completed extension request form and a letter, it had substantially complied with the regulations in filing the payment extension. The Court ruled that the substantial compliance doctrine does not apply to essential regulations, such as those governing a request for an extension of time to pay estate taxes. The substantial compliance doctrine applies only to regulatory requirements that are procedural, unclear, or relatively unimportant. Here, the estate had failed to include the desired extension period, which the Court deemed to be a necessary piece of information. 2) The estate claimed that the IRS should be equitably estopped from the assessment of penalties and interest since it had not informed Baccei that the extension request was deficient. The Court ruled that the IRS had not engaged in the kind of affirmative misconduct, such as affirmative misrepresentation or concealment of a material fact, that could justify estoppel. 3) The estate claimed that its reliance on the accountant constituted reasonable cause under U.S.C. § 6651(a)(2) for its failure to properly request late payment. The Court held that Baccei, and not the accountant, was responsible either for identifying the payment deadline and ensuring payment, or for applying for an extension. He failed to establish that he exercised ordinary business care and prudence.

IRS FORM 8939

IRS Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, is still in development. A draft is available at http://www.irs.gov/pub/irs-dtf/f8939--dft.pdf. IRS Form 8939 is necessary to allocate the $1.3 million basis adjustment allowed for any heirs and the additional $3 million basis adjustment allowed for continued on Page 28
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surviving spouses of decedents who die in 2010. Soon after the final Form 8939 is available, Instructions for Form 8939 and Publication 4895, Tax Treatment of Property Acquired From a Decedent Dying 2010, will be also be available.

The IRS has modified its former guidance about the procedures for filing the form. Updated procedures will be found in the Instructions for Form 8939 and in Publication 4895. The election under Section 301(c) of Public Law 111-312 to use the modified carryover basis rules should not be made on the decedent’s final income tax return.

IR-2011-33 (March 31, 2011)

Form 8939, Allocation of Increase in Basis for Property Acquired from a Decedent, is not due on April 18, 2011 and should not be filed with the final Form 1040 of decedents dying in 2010. The deadline for filing will be provided in future guidance, and when this guidance is published a reasonable period of time will be allowed for the preparation and filing of Form 8939.

II. FEDERAL GIFT TAX


Thomas W. Gaughen had timely filed a 2005 federal gift tax return reporting gifts of ownership interests in seven pieces of real estate in Cumberland County, PA. The IRS audited the return and filed a Notice of Deficiency, claiming that Gaughen had undervalued three of the properties by a total of $2.36 M and assessing additional gift tax liability of $1.06 M, a fraud penalty of $791K and interest of $494K. Gaughen paid the taxes, penalties and interest and filed a motion claiming that the fraud penalty was assessed in error because the government had not “stated with particularity the circumstances constituting fraud” under FED. R. Civ. P. 9(b). In this action, he sought refund of the penalty for fraud assessed against him.

The Court ruled that although the taxpayer initiated the proceeding, the government has the burden of proving fraud under 26 U.S.C. Section 7454(a) and that it must satisfy the pleading requirements of Rule 9(b). The District Court therefore denied Gaughen’s motion for judgment on the pleadings without prejudice and granted the government leave to amend its answer.


The Court reversed the district court’s grant of summary judgment in favor of the government, holding that genuine issues of material fact exist in the determination of whether the Lintons’ gifts to their children’s trust should be valued as indirect gifts of specific assets or gifts of LLC Interests. The case was remanded to the district court to determine the sequence of transactions by which the gifts were made. The Court also overturned the district court’s ruling that a step transaction had occurred.

The Lintons claimed to have gifted interests in an LLC, whereas the government claimed that they had gifted cash, securities and real property. The controversy arises from the determination of whether the funding of the LLC occurred before or after the transfer of LLC interests to the children’s trusts. On January 22, 2003, William and Stacy Linton funded WFLB Investments, LLC and signed one trust agreement for each of their four children and gift documents. But they left the trust agreements and gift documents undated. Several months later, the attorney assembling the documents filled in the missing dates as January 22, 2003. In his deposition, the attorney claimed that the documents should have been dated January 31, 2003, and the Lintons’ accountant presented evidence supporting the later date. The IRS rejected the Lintons’ application of a 47% ownership and control discount on their gift tax return because it claimed that either the Lintons had made indirect gifts of cash, securities and real estate or that, in the alternative, under the step transaction doctrine, the gifts should be treated as gifts of cash, securities and real estate.

The district court relied on the language in the trust agreements and gift documents to determine that the all of the events occurred on the same day, concluding that the transfers of real estate, cash and securities “constitute[d] indirect gifts to the Trusts of pro rata shares of the assets conveyed to the LLC.” Noting that there was no evidence that the Lintons had made an affirmative decision to delay the gifts, and that there was no indication that the trust corpus was exposed to economic risk between the contributions to the LLC and the gifts of the LLC interests to the children’s trusts, the district court also held that the step transaction doctrine applied to the transactions under any of the three applicable tests: (i) the binding commitment test; (ii) the end result test; and the (iii) interdependence test.

The Appeals Court looked to the four elements of a completed

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**Transfer Tax Update, continued**

Gift under Washington state law: 1) the intention of the donor to give; 2) subject matter capable of delivery; 3) delivery; and 4) acceptance by the donee. It determined that the second and third elements were both present on January 22, 2003, and that the fourth element is presumed because the gift was not disclaimed. Thus the presence or absence of the intent to donate would determine whether the gift of LLC interests occurred on January 2, 2003.

The Court noted that “a writing, on its own, is not a sufficient objective manifestation of intent to donate at the time of the writing, or at all. Circumstances surrounding the writing must show if the writing was meant to be effective.” More generally, “the determinative question as to when the gift of the LLC interests occurred is the first date at which objective circumstances existed that would suggest the gift documents were meant to be operative (and all three other elements of a gift existed under Washington law).” Because there is no evidence of the record of such circumstances, the case was remanded to the district court to determine at what time such circumstances existed.

**III. GENERATION-SKIPPING TRANSFER TAX**


The U.S. District Court, N.D. Mississippi granted the Hobbs’ motion for reconsideration as to its claims for generation-skipping transfer tax liability. In its opinion dated January 11, 2011, the Court had granted Legg Mason’s Motion for Partial Summary Judgment and dismissed the Hobbs’ claim that under Tennessee law, Legg Mason had breached its duty to modify a trust and had thereby rendered the Plaintiffs liable for unnecessary GST taxes. Upon reconsideration, the Court reaffirmed its original determination that Legg Mason had no duty to modify the trust. However, the Court now recognized that Legg Mason may have breached its fiduciary duty as a trustee under other theories of liability asserted by the Plaintiffs. It reversed its earlier finding that, under Tennessee law, Legg Mason did not breach its fiduciary duty “to keep the beneficiaries of a trust …reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interest.” Tennessee Code Section 35-15-813(a)(1).

**IV. PRIVATE LETTER RULING**

PLR 201101001 through 201101008 (January 7, 2011)

The IRS held that an agreement among a decedent’s great-grandchildren after years of litigation would not cause the trust distributions to be subject to the GSTT. The trust was created and funded before the GSTT rules for trusts created or funded after 9/25/85 came into effect. The settlement agreement was based on a “sophisticated algorithm taken to thirteen decimal places.” The court also ruled that because the agreement was the product of arm’s length negotiations in the settlement of a bona fide controversy between the parties, the resulting transfers would not be subject to gift or estate taxes and the great grandchildren would not have to include any undistributed trust assets in their gross estates.

**NEWSLETTER ARTICLES**

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

David A. Ruben
email: davidaruben@gmail.com
Bosley Estate and DeHaas Estate
Further Develop Issue of Capacity to Execute a Power of Attorney

By ADAM T. GUSDORFF
BALLARD SPAHR LLP

Two recent cases have added to the growing body of case law regarding the capacity required to execute a power of attorney. In the past several years, cases such as Govett, Incapacitated Person, 23 Fiduc. Rep. 2d 287 (O.C. Chester 2003), In re McKinney, 27 Fiduc. Rep. 2d 359 (O.C. Chester 2007), Robinson, Incapacitated Person, 28 Fiduc. Rep. 2d 65 (O.C. Montg. 2008) and DiStefano Trust, 30 Fiduc. Rep. 2d 1 (O.C. Phila. 2009) have addressed this issue, but no single legal standard or test has emerged. Other important considerations that surface in some of these cases are the utility of having medical expert testimony and/or scrivener testimony, and the balancing act that ensues when there are both.

In the latest cases to tackle the issue, Bosley Estate, 1 Fiduc. Rep. 3d 185 (O.C. York 2010) and DeHaas Estate, 1 Fiduc. Rep. 3d 225 (O.C. Chester 2011), each court invalidated the power of attorney at issue, but for different evidentiary reasons and after applying somewhat different legal standards. The cases are important to review not only to understand what legal standards a court may apply, but also the nature of evidence it might consider or require.

In Bosley, the validity of the power of attorney was a small issue in a case that otherwise presented as a law school exam. In a 35-page opinion, the Orphans’ Court considered domicile, a three-pronged Will contest, fiduciary removal, propriety of lifetime transfers and the equitable defense of unclean hands, in addition to the power of attorney issue. The decedent, Donald Bosley, who was illiterate, was survived by his two brothers, Daniel and Kenneth, and by a cousin, David. Kenneth contested Donald’s Will, which had been executed in 2003, on multiple grounds and sought the removal of David as Executor. Kenneth was the proponent of (and agent under) the power of attorney, which Donald had executed by mark in 2007. Certain lifetime transfers to Kenneth, from 2005 to 2007, also were at issue.

As a threshold matter, Judge Penny L. Blackwell noted that “[l]ess capacity is needed to make a will than is needed to transact ordinary business, to make an inter vivos gift, or to establish a valid power of attorney.” Bosley, 30 Fiduc. Rep. 3d at 200. She observed that these competing standards made Kenneth’s positions – that the 2003 Will was invalid, but the subsequent inter vivos transfers and execution of the power of attorney were valid – irreconcilable. See id.

Ultimately, Judge Blackwell determined that the power of attorney was invalid because Donald lacked the requisite mental capacity. See id., 1 Fiduc. Rep. 3d at 202. In doing so, she applied both the three-part test set forth by Judge Ott in Robinson and a test based on the Restatement of Agency applied by Judge Wood in Govett.

In Robinson, Judge Ott ruled that a person has capacity to execute a power of attorney if he understands (1) the nature of the authority given to the agent, (2) what assets would be subject to the power, and (3) the plain language of the notice provision required by 20 Pa. C.S. § 5601(c). See Robinson, 28 Fiduc. Rep. 2d at 82. This test has been applied by the Philadelphia Orphans’ Court, which invalidated a power of attorney in DiStefano, a case that Judge Blackwell relied upon. See Bosley, 1 Fiduc. Rep. 3d at 202-03. In Govett, on the other hand, Judge Wood had found the relevant inquiry “for determining whether one is capable of appointing an agent is whether one is capable of giving a legally operative consent.” Govett, 23 Fiduc. Rep. 2d at 289 (citing Restatement (Second) of Agency § 20).

Judge Blackwell applied both of these tests to the particularly egregious set of facts before her. Based on anecdotal evidence from lay witnesses – including Kenneth – she concluded that Donald lacked the capacity to understand the nature of the authority given to the agent or the significance of his actions in signing the document by mark. (Regarding the latter, Kenneth testified

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the net proceeds to sold the house and gave one-third of (power of attorney for her husband had been named agent under a 2004 the prior payment to seeking all net proceeds of sale, less as his Executrix, filed an objection mond’s death, he filed his account following Ray -son from an earlier marriage and that to w ants by the entireties, into her name which had been titled jointly as ten-
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cal testimony. In doing so, he gave the medical testimony greater weight than he did to that of the scrivener of the power. See DeHaas, 1 Fiduc. Rep. 3d at 229-33; cf. Robinson, supra (weighing testimony of scrivener over that of the treating psychiatrist).

Judge Drayer’s opinion also included a short discussion of Masciantonio Estate, 141 A.2d 363 (Pa. 1958), which set forth a balancing test for courts to use when considering conflicting testimony of physicians and scriveners. See DeHaas, 1 Fiduc. Rep. 2d at 229 (stating that “the courts give credence to the opinions of these professionals if they had adequate opportunity to observe the principal at or near the time of execution of the instrument”).

Judge Drayer heard testimony from Raymond’s treating physician, who saw Raymond frequently during the period in question and opined that Raymond did not have the ability to understand the power of attorney or to make decisions for himself. See DeHaas, at 231. The court also heard testimony from Raymond’s neurologist, who also saw him multiple times during that time and stated that Raymond did not have the cognitive ability to understand the consequences of signing a power of attorney. See id. at 232.

The court contrasted the medical testimony with that of the scrivener of the power, who could not recall details about the meetings that led to the execution of the power, including any discussion about gift provisions or the retitling of the house. The court found that the scrivener also “failed to take appropriate steps to verify Raymond’s capacity,” particularly in light of “the fact that Raymond obviously ha[d] severe limitations.” Id. at 232-33. Without specifically applying the Robinson factors, the court concluded that Raymond lacked capacity, invalidated the power of attorney and directed Regina’s executor to pay all net proceeds of sale to Raymond’s estate.

As more Orphans’ Courts address the issue of what mental capacity is required to execute a power of attorney, it is likely that the legal standards will be further clarified and, perhaps, we will ultimately receive guidance from the appellate courts. In the meantime, practitioners should be prepared to address and apply the various standards set forth by the Orphans’ Court in Bosley and DeHaas, and consider whether expert testimony is necessary or appropriate.
Committee Updates

Business Planning Committee

BY DENNIS C. REARDON

We are launching a new Business Planning Committee as part of the Probate and Trust Section of the Philadelphia Bar Association. The new Committee will focus primarily on the planning needs of closely held businesses, with an emphasis on family owned businesses, in which both tax and nontax issues of the business intersect with the estate and financial planning needs of the family. In that regard, we expect to focus on the business succession planning needs of our clients, in that those concerns necessarily double back to the estate planning world where our Section members live.

For my part, beyond experience in practice, I’ve benefited from being a member of the Business Planning Committee of the American College of Trust and Estate Counsel during the past several years. I plan to add any planning thoughts derived from that group as we proceed. Far beyond that, our Section, and the Bar Association, more generally, has many members who have insight from many different perspectives. In that regard, we hope that members of the Tax Section who deal with planning issues of the type described above can join us.

In inviting our members to join this Committee, I hope to persuade those who are senior members of their firms to join us, at least in the beginning, so that we may incorporate the most wide ranging mix of topics known to those who have substantial experience. Those who have brought their talents to bear in the past often move on to make room for younger members as a natural part of the bar membership process. Here, we are trying to institute a group that can attract other members because of the quality of its experience and intellectual background. Having said that, I hasten to add that the new committee welcomes members of all ages and levels of experience to bring ideas and professional commitment to the group.

Our initial meeting was held on Friday, May 6, 2011. If you would like to attend future meetings, please send an e-mail message to DCarey@DReadronLaw.com or Nina.Stryker@obermayer.com.

Guardianship Handbook Committee

BY KEELIN S. BARRY & RISE P. NEWMAN

The Hearing has ended and you have been appointed to serve as plenary Guardian for an incapacitated person and their estate. Now the fun starts as you wonder where to begin, what direction to follow, and who to call for some help.

If the incapacitated person is able to remain in the community with the assistance of services, where do you go for those services? How do you, as guardian, become the social security representative payee? What do you do with the incapacitated person’s car, particularly when they think they are a safe driver? How do you leave the incapacitated person with the feeling of some control and independence? How do you begin and maintain a relationship with someone who was a relative stranger yesterday but today is your responsibility? If, the incapacitated person for whom you are serving as guardian

Young Lawyers’ Committee

By ALISON GROSS

The Young Lawyers’ Committee had its first meeting on February 17th. Over thirty younger members of the Section attended to brainstorm ideas for future meetings and events.

Since then, lunch discussion groups based on years of experience have formed, organized by Barbara Little of Schnader Harrison, Marguerite Weese of Wilmington Trust, and Justin Brown of Stradley Ronon. We also had a meeting on May 19th which featured a seminar on “What Probate Lawyers Need to Know About Family Law.” Finally, the Committee will be sponsoring a joint happy hour with the young lawyers of the Tax Section on June 8th.

Please e-mail Alison Gross, chairperson of the Young Lawyers’ Committee, at alison@altmangross.com if you are interested in getting involved.
ian is not independent enough to remain in the community how do you find a proper placement? How do you sell their house and what are you permitted to do with the proceeds? Do you need court permission? What do you do as guardian if, several years after your appointment, the incapacitated person, thanks to treatment, is no longer in need of a guardian?

Several years ago, the co-authors of this article were asking the exact same questions and as the then co-chairs of the Elder Law Committee of the Probate and Trust Law Section of the Philadelphia Bar Association, formed a sub-committee to draft a Guardianship Handbook.

The Guardianship Handbook Committee is composed of attorneys practicing in different aspects of estate planning, administration, elder law, and guardianship law. Other members of the Guardianship Handbook Committee include elder law mediators. The goal of the Committee was to present the Probate and Trust Section with a useable resource for attorneys serving as guardian in order that their job as guardian runs as smoothly as possible. The handbook was the vision of Orphans’ Court practitioners who saw the need to provide guidance for those attorneys unfamiliar with the day to day procedures and potentially daunting task associated with serving as an individual’s guardian. The Guardianship Handbook is meant to provide some answers and to shed some light on the many questions that arise.

The Guardianship Handbook is includes the following chapters: Alternatives to Guardianship, Statutes and Legal Mechanics, Rights of the Alleged Incapacitated Person and the Incapacitated Person, Responsibilities and Duties of the Guardian, Health Care Issues in Guardianship, The Role of Mediation in Adult Guardianship, Estate Planning for Incapacitated Persons, a Glossary, and includes applicable Pennsylvania Rules of Professional Conduct, various Checklists and sixteen (16) different forms, reports and petitions.

It is the hopes of the of Committee as well as the Probate and Trust Section that this resource will encourage attorneys to assist the Orphans’ Court and serve as guardians as well as provide support to the generous members of the Philadelphia Bar who already take on these challenging situations for little or no money.

Because the Handbook includes statutes, checklists, forms, and other resources, it is an invaluable guidebook for those serving as guardian. The Handbook may be accessed through the Probate and Trust Section homepage of the Philadelphia Bar Association website. The Handbook was posted September 16, 2010.

Because the Guardianship Handbook Committee would like feedback and input from other practitioners this Handbook is presented as a draft. Your corrections, suggestions for change, and additions are welcome. After approximately one year, the committee members will incorporate comments and suggestions to create a “final” Handbook. Of course, given today’s technologies, comments and suggestions can continue to be incorporated beyond that time. Send your suggestions and comments to: guardianshiphandbookcomments@gmail.com

We encourage everyone in our section to serve, at least once as a guardian. The waters are no longer as rough as they once were, there are available resources, and you will enrich your practice area exponentially.