Report of the Chair

By ROBERT I. FRIEDMAN
COZEN O’CONNOR

Although the year seems to me to be flying by, it has been so far a very busy year for the Section.

Two projects are worthy of special note.

First, I am very pleased to report on our new Guardianship Manual, which we expect to post on our website in September.

The Orphans’ Court frequently asks our Section to provide volunteer guardians in appropriate cases, but this responsibility has been largely taken on by only a core group of attorneys. For many years we have discussed how the availability of a manual would help expand the number of otherwise willing participants who would commit to help in this important work, as well as be a valuable resource to all Section members who practice in this area.

Our Elder Law Committee, through its Guardianship Handbook Sub-Committee, has worked diligently on this project over the past two years and has now produced a very impressive Manual. It will shortly be posted as a draft with an open request for suggestions and comments, and with the idea that after an appropriate comment period the Manual will be finalized and further publication will be considered.

On behalf of the Section, I extend my thanks and congratulations to those who have made this idea a reality:

First and foremost, Keelin S. Barry and Rise P. Newman, co-Chairs of the Sub-Committee, contributing authors, and tireless advocates for our Section’s work in this area.

Barbara Foxman, Kathryn Mariani, Suzanne Pritchard, Anna Sappington, Carol Soskis and Gordon Wase, each a contributing author.

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Report of the Chair, continued

Ann S. Maxwell, who provided the sample petitions which are included in the Manual, and Laura Ritchie and Howard Solomon, Sub-Committee members.

The second project which must be acknowledged is the work of our Legislative Committee in considering the need for state legislation to address the construction of wills and trusts containing federal tax formula clauses in a world which has no federal estate tax and no generation-skipping tax exemption.

The Committee got to work on this quickly and produced a proposed statute; the principal drafter was Committee member Michael Stein.

After review at our Executive Committee, the proposed statute was forwarded to the Advisory Committee to the Joint State Government Commission, which, with some tweaking, proposed it for adoption. Of necessity on a fast track if it is to be as useful as possible, it has now been added to Senate Bill 53. This Bill awaits review when the state Senate reconvenes in September. Although passage this year is uncertain, I think we can and should take credit for addressing an issue of importance to our Section and for taking a laboring oar in working diligently for adoption of a timely and useful statute.

My thanks to all those who have contributed to these two projects and to all other Section members who have been so active in the other committee work of our Section this year.

New Roth IRA Conversion Opportunity Helps to Support Philadelphia Bar Foundation

By KEVIN GILBOY
TEETERS HARVEY GILBOY & KAIER LLP

Here’s a way for your lawyer estate planning clients (or even yourself) to take advantage of the new Roth IRA conversion opportunity while supporting the Philadelphia Bar Foundation, the charitable organization that furnishes crucial support to legal services for impoverished members of our community seeking access to justice where basic human needs are at stake.

Many lawyers’ most significant asset is their retirement plan, whether a conventional IRA, or other tax qualified retirement plan, such as a 401(k). While these retirement plans offer current income tax deferral, they often do not make very flexible estate planning assets. The deferred income tax liability makes such assets unattractive for funding credit shelter trusts (assuming the estate tax and credit shelter trusts return in 2011) and the rules for required minimum distributions generally don’t work easily with trust beneficiaries.

For the lawyer-client, Roth IRAs offer several attractions - such as no required minimum distributions during the lawyer’s lifetime and no income tax on most distributions. Up until now, however, Roth IRAs have not been an option for many lawyers because of maximum income restrictions. But starting in 2010, a traditional IRA or other retirement plan can be converted to a Roth IRA without regard to the taxpayer’s income level1.

Post death distributions from a Roth IRA still have to meet the required minimum distribution rules, including the “designated beneficiary” rules that make trust planning with conventional IRAs difficult. But even the required minimum distribution payments from the Roth IRA are generally income tax free.

The downside of the Roth IRA conversion is the required income recognition of the entire amount converted. Taxpayers converting in 2010 do have the one-time option of spreading the income tax hit over two tax years (2011 and 2012). Most financial advisers suggest that if the taxpayer can bear to pay the income tax from other (non-retirement plan) assets, the Roth IRA conversion can generate significant economic benefits over time from the tax free growth.

The income tax burden of the Roth IRA conversion can be mitigated by gifts to charity. While an outright gift to charity will produce an offset-

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continued on Page 3
Roth IRA Conversion Opportunity, continued

It is important to note that the income tax deduction, it also reduces the available assets working to produce income for the lawyer-client.

But your lawyer-client can have it both ways by making a gift to a charitable remainder trust. Such a gift produces a current income tax deduction for the client (although not dollar for dollar) while still providing a current return for the lawyer as beneficiary.

For example, suppose a 60 year old lawyer wants to convert one-half of his or her $500,000 retirement plan to a Roth IRA. The $250,000 outright conversion would be subject to an income tax of $87,500, assuming a tax rate of 35%. But if in the same year the lawyer created a $100,000 5% charitable remainder unitrust (“CRUT”) and funded it with cash or non-dividend paying stock, the lawyer would receive a current income tax deduction of approximately $38,000. Ignoring the general limitations on itemized deductions, the creation of the CRUT would reduce the income tax hit on the Roth IRA conversion from $87,500 down to $49,500. In addition, the lawyer would increase his or her current cash flow by the $5,000 unitrust payment from the CRUT, adjusted each year for changes in the value of the trust.

In the CRUT, the lawyer-client could name the Philadelphia Bar Foundation as the charitable organization to receive the remainder of the trust at the lawyer’s death. Such a gift to the Bar Foundation, which will support the delivery of legal services to needy Philadelphians in the future, will enhance both our community and the best definition of what it means to be a “Philadelphia lawyer.”

As with any charitable remainder trust planning, this increase in cash flow could be used in part to purchase life insurance in an irrevocable trust to replace for the lawyer’s family the $100,000 used to fund the CRUT.

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Sipe Estate and Waiver of the Dead Man’s Rule

By ADAM T. CUSDORFF
BALLARD SFAHR, LLP

The ability to assert the Dead Man’s Rule to prevent an adverse witness or party from testifying is perhaps the strongest weapon a decedent’s representative can have. Sometimes a representative will have to waive the Rule’s application out of necessity or will waive it as a tactical decision. The most important thing, however, is that waiver of the Rule should always be a conscious decision. Because waiver can lead to testimony from an interested witness that may be impossible to contradict, it is critical for the personal representative’s counsel to know what pitfalls to avoid. On the other hand, if you represent the incompetent witness, you need to be able to recognize methods of waiver so you can take advantage when it occurs.

A recent York County decision serves as a reminder that Orphans’ Court practitioners should be well-versed in the application of the Dead Man’s Rule and the various ways in which it may be waived at trial. Although the adverse party won the case due to a lack of evidence presented by the estate, the case should serve as a cautionary tale.

In Sipe Estate, 30 Fiduc. Rep. 2d 255 (O.C. York 2010), the decedent’s five children were the Executors of her Will and were the beneficiaries of her residuary estate. At her death, a credit card held in decedent’s name had an unpaid balance of $7,923.69. The credit card company later agreed to accept $3,976.85 in full satisfaction of the claim.

Subsequently, three of the Executors filed an account of their administration and took the position that the residuary share of one of the other children, George Sipe, should be offset by $3,976.85 because, they alleged, the credit card balance constituted a loan from the decedent to George.

The Executors seeking offset (the “Accountants”) took the position that George was incompetent to testify under the Dead Man’s Rule, 42 Pa. C.S.A. § 5930.

The Dead Man’s Rule addresses the threshold ability of a witness to take the stand and is not an evidentiary rule addressing the admissibility of the proposed testimony. Simply put, the Rule provides that “surviving parties who have an interest which is adverse to [the] decedent’s estate are disqualified from testifying as to any transaction or event which occurred before [the] decedent’s death.” Hera v. McCormick, 625 A.2d 682, 688 (Pa. Super. 1993). Where a person is disqualified, he may not testify as to any transaction or event which occurred before the decedent’s death. See, e.g., Schrader v. Jaquiss, 861 A.2d 885, 887 (Pa. 2004); see also 42 Pa. C.S.A. § 5930 (prohibiting testimony by an incompetent witness regarding “any matter occurring before the [decedent’s] death”). Thus, the disqualification is not limited to testimony regarding the actual transaction or agreement that gives rise to the claim. Instead, the incompetent witness “is not permitted to testify as to any relevant matters occurring before the decedent’s death, even though they be independent facts which in no way can be regarded as transactions with, or communications by, the decedent.” In re Estate of Cecchini, 485 A.2d 454, 458 (Pa. Super. 1984).

Three conditions must be met for a witness to be incompetent to testify: (1) the deceased must have had an interest in the matter at issue, i.e., an interest in the immediate result of the suit; (2) the interest of the witness must be adverse; and (3) a right of the deceased must have passed to a party of record who represents the deceased’s interest. Estate of Rider, 409 A.2d 397, 399 (Pa. 1979).

George proposed to testify as his only witness, whereupon counsel for the Accountants timely objected to George’s competence under the Dead Man’s Rule. The court, by Judge Penny L. Blackwell, permitted George to testify because “it was not clear whether he would testify concerning matters before or after decedent’s death.” Sipe, 30 Fiduc. Rep. 2d at 262. George’s subsequent testimony about the credit card balance was entirely about events that occurred prior to the decedent’s death. See id. at 263, n.4.

The Court applied the Rider factors listed above and properly concluded that George was incompetent to testify about events that...

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Sipe Estate and Waiver of the Dead Man’s Rule,

occurred prior to the decedent’s death, stating that “the Court has not relied on those pre-death statements in reaching its holdings here.” Id. As an aside, it is unclear from the opinion why, when the objection was initially raised, the Court did not sustain it and instruct George’s counsel to confine his examination to post-death events, as the Rider elements were satisfied regardless of the testimony he gave.

After George testified under direct examination, counsel for the Accountants cross-examined him with respect to events that occurred during decedent’s lifetime. See id. at 262-63. As soon as he did so, the Accountants waived the right to assert the Rule and rendered George competent to testify as to pre-death events. See Estate of Kofsky, 409 A.2d 1358 (Pa. 1979). The rationale for waiver under such circumstances is that cross-examining the incompetent witness on pre-death events makes the witness the representative’s own “‘and accredits him just as though he had called him in chief in the first instance, without qualification or restriction.”’ Id., 409 A.2d at 1359 (quoting Goehringer’s Estate, 106 A. 60, 62 (Pa. 1919)).

Despite the patent waiver, the parties appeared to proceed to the conclusion of the hearing without recognizing that a waiver had occurred. For example, George’s counsel did not raise lifetime issues on re-direct, see Sipe, 20 Fiduc. Rep. 2d at 263, n.4, or seek to revive George’s testimony by arguing that a waiver had occurred. As for the Accountants, in a post-hearing letter memorandum, they continued to take the position that George was an incompetent witness. See id. at 261, n.3.

In her opinion, Judge Blackwell acknowledged that Accountants had waived the Rule by their cross-examination of George. See id. at 263, n.4 (citing Kofsky, supra). Nonetheless, she did not consider any of George’s testimony of lifetime events in reaching her conclusion because he was not re-examined on pre-death matters following cross-examination. See id. Could the Judge, in ruling on the Dead Man’s Rule objection after the hearing, have overruled it as a result of the waiver? Certainly, but it is not the Court’s role to identify and make arguments that the parties have abandoned or overlooked. Moreover, George was not harmed by the decision not to consider his testimony about lifetime events, because Judge Blackwell ruled in his favor on the merits.

The main lesson for practitioners to take from Sipe is to be able to recognize when the Dead Man’s Rule has been waived and how to address a waiver that occurs during the hearing. In addition to a waiver occurring through cross-examination of the adverse witness regarding pre-death events, waiver occurs during a hearing when the decedent’s representative calls the adverse witness to testify. See 42 Pa. C.S.A. § 5932. In addition, a limited waiver occurs when the decedent’s representative calls and examines another witness regarding pre-death matters that took place in the presence of the adverse witness. See 42 Pa. C.S.A. § 5933; In re Gelb’s Estate, 228 A.2d 367 (Pa. 1967).

Had the Accountants had a stronger case, their waiver of the Rule could have proven disastrous, because it gave George the opportunity, albeit unexploited, to give uncontradicted testimony. Once George had been cross-examined on pre-death events, his counsel could have addressed the waiver and sought a ruling at that time or simply re-examined him. Had the Court sustained the Dead Man’s Rule objection prior to George’s testimony or prior to cross-examination, counsel could have moved the Court to reconsider its decision as another means of reviving George’s testimony of pre-death events.

In the end, the absence of George’s testimony about pre-death events did not hurt him, as he prevailed. However, many similarly situated parties will not be so fortunate, while many personal representatives will not always be able to avoid the consequences of a Dead Man’s Rule waiver.

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
Case Summaries from the Orphans’ Court Litigation Committee

In re: Novosielski, 992 A.2d 89 (Pa. 2010)

By TIMOTHY J. HOLMAN, ESQUIRE AND BRADLEY D. TEREBELO, ESQUIRE
HECKSCHER, TEILLON, TERRILL & SAGER, P.C.
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ED. NOTE: The Orphans’ Court Litigation Committee will provide summaries of recent litigation cases in each quarterly newsletter. The authors thank Dawn Meyer, Esquire, also of Heckscher, Teillon, Terrill & Sager, P.C., who contributed to this case summary.

For the past few years, the disposition of joint accounts, especially so-called “convenience accounts,” was not as clear as the governing statute would lead practitioners to believe. Section 6304(a) of the Multiple-Party Accounts Act (“MPAA”), 20 Pa. C.S. §§ 6301-6306, states in relevant part as follows (emphasis added):

(a) Joint account. Any sum remaining on deposit at the death of a party to a joint account belongs to the surviving party or parties as against the estate of the decedent unless there is clear and convincing evidence of a different intent at the time the account is created.

In two opinions by the Pennsylvania Superior Court, In re Estate of Novosielski, 937 A.2d 449 (Pa. Super. 2008) and In re Estate of Piet, 949 A.2d 886 (Pa. Super. 2008), the Superior Court held in relevant part that where a joint account is created after a validly executed will, and the joint account provides for a different disposition of the jointly held asset than the will did had the asset remained in the will, the terms of the previously existing will constitute clear and convincing evidence that the presumption of a right of survivorship under 20 Pa. C.S. §6304(a) should be defeated. The Pennsylvania Supreme Court in In re: Novosielski, 992 A.2d 89 (Pa. 2010) reversed the Superior Court as summarized below.1

Alice G. Novosielski, the decedent ("Alice"), executed a valid will in 1995, leaving her estate in equal shares to her five sisters, per stirpes. Only one sister survived Alice. Following the execution of her will, Alice named her nephew, Thomas Proch ("Thomas"), a power of attorney. In 2000, Alice executed a codicil to her will, naming Thomas executor, making additional bequests, and ratifying her 1995 will “in all other respects.” Four days later, Alice created a Treasury Direct Account titled in the name of “Alice G. Novosielski or Thomas V. Proch” that held a majority of her assets.

Following Alice’s death on November 16, 2001, Thomas, as executor, filed a final accounting of Alice’s estate which excluded the Treasury Direct Account. Alice’s surviving sister filed an objection to the accounting because the Treasury Direct Account was not included. The Orphans’ Court appointed a special master to take testimony and issue a report and recommendations on the objections. The master recommended that Thomas be surcharged $96,059 because he breached his fiduciary duty in various ways, but he also recommended that the Orphans’ Court find that Thomas was sole owner of the Treasury Direct Account. The Orphans’ Court assessed a surcharge against Thomas, but it went against the master’s recommendation that Thomas be determined to be the sole owner of the Treasury Direct Account and instead found that Alice’s estate was the proper owner of the Treasury Direct Account.

As mentioned above, the Superior Court affirmed the Orphans’

1 On July 21, 2010, the Pennsylvania Supreme Court issued an Order without opinion vacating the Superior Court in Piet and remanding it for further consideration in light of the Supreme Court’s Novosielski decision. In re: Piet, --- A.2d ---, 2010 WL 2850905 (Pa. 2010).

2 The surcharge was not appealed to the Pennsylvania Supreme Court.

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Court, holding that the Treasury Direct Account was a type of joint account governed by the MPAA and that the contrary dispositive scheme in Alice’s previously existing will was clear and convincing evidence to rebut the presumption of survivorship under 20 Pa. C.S. §6304(a), stating, “[w]hen the execution of a valid will pre-dates the creation of a challenged MPAA joint account, we must consider whether the intentions expressed in the will can be read in a manner that is consistent with the decision to place assets in the MPAA joint account. If we cannot find such consistency the expression of intent in the will must control unless we determine that the creation of the joint account functions as a revocation of the validly executed will’’ and that “blindly deferring to the § 6304(a) ownership presumption’’ would lead to frustration of testamentary intent and could result in fraud. In re Estate of Novoselski, 937 A.2d 449, 457 (Pa. Super. Ct. 2007) rev’d sub nom. In re Novoselski, 992 A.2d 89 (Pa. 2010).

The Supreme Court addressed three issues on appeal:3

1. Did the Superior Court err in holding that the presumption of survivorship under 20 Pa.C.S.A. § 6304(a) is defeated, per se, if the joint account results in an allocation of the estate that is inconsistent with an existing will? 

2. Did the Superior Court err in determining, under 20 Pa.C.S.A. § 6304(a), that there was clear and convincing evidence of a different intent at the time the account was created?

3. Did the Superior Court err in failing to accord the factual findings of the master the same weight and effect as a jury verdict?

The Supreme Court first noted that the Superior Court correctly concluded that the Treasury Direct Account is a joint account governed by the MPAA; however, the Supreme Court held that the Superior Court erred by concluding that the provisions of Decedent’s will, together with Decedent’s ratification of that will by codicil near the time of the creation of the Treasury Direct account, constituted clear and convincing evidence that Decedent did not intend there to be a right of survivorship at the time the account was created. Novoselski, 992 A.2d at 102. Specifically, the Supreme Court noted that there is no statutory provision “giving a will priority over the right of survivorship presumed by Section 6304(a) [of the MPAA], nor does anything in the MPAA or the PEF Code support the Superior Court’s path of interpretation.” Id. Quite the contrary, the Supreme Court noted that Section 6306 of the MPAA states: “No transfer resulting from the application of section 6304 (relating to right of survivorship) shall be considered as testamentary or subject to Chapter 21 (relating to intestate succession) or Chapter 25 (relating to wills).” Id. quoting 20 Pa. C.S. §6306 (emphasis in Supreme Court opinion).

While the Supreme Court held that the Superior Court “erred by concluding that a right of survivorship created by a joint account governed by the MPAA is defeated merely because provisions of a will would distribute a decedent’s property in a different manner[,]” Novoselski, 992 A.2d at 103, it did note that the provisions of a will could still be considered as evidence in determining whether the right to survivorship presumption should apply. Id. at 102. Accordingly, the Supreme Court considered the final two issues on appeal. In addition to finding contrary intent in Alice’s will and codicil rebutting the presumption of joint ownership, the Superior Court also based its holding on the alleged fact that Alice suffered from a “perilous mental condition.” In re Estate of Novoselski, 937 A.2d 449, 458 (Pa. Super. 2008). However, the special master found that Alice “possessed the mental sharpness to make a knowing execution of the Testator.” In re Novoselski, 992 A.2d 89 at 104 (Pa. 2010). Because the Orphans’ Court did not disturb this finding, the Supreme Court held that it was “improper for the Superior Court to ‘find’ that Decedent suffered from mental confusion and thus conclude that the Treasury Direct account’s right of survivorship must be set aside for that reason.” Id. at 104-105.

Finally, the Supreme Court turned to the Orphans’ Court’s finding that the Treasury Direct Account was an asset of Alice’s estate based on its finding that the Treasury Direct Account was a convenience account and was not intended as a present gift to Thomas. The Supreme Court held that the Orphan’s Court findings were in error because the creation of a joint account does not create a present gift and that “joint accounts with rights of survivorship are typically created as ‘convenience accounts’ to allow caretakers to assist senior citizens with the management of their finances.” Id. at 105. The case was then remanded to the Orphans’ Court.

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Case Summaries from the Litigation Committee, continued

Court “for treatment consistent with this opinion.” Id. at 108.

With the Supreme Court’s reversal of the Superior Court and Orphans’ Court, the uncertainty created by the Superior Court in Novoskielki and Piet was clarified – once again, “joint means joint.” The Supreme Court did not, however, cut off all avenues to contest the disposition of jointly held assets, and the dispositive terms of a will may still be used as evidence of contrary intent – it is just no longer per se clear and convincing evidence to rebut the presumption of the asset to the surviving joint owner.

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Practice Points

Miscellaneous File Numbers for Non-Probated Estates

By Bernice J. Koplin and Karen Conn Mavros, Esquires

Readers are encouraged to send their questions or ideas for consideration in future columns to Bernice J. Koplin at bjkoplin@sglk.com.

In some situations, it is necessary to prepay (for the five percent “discount”), pay, or request an extension of time to pay the Pennsylvania Inheritance Tax for a Decedent in which no Estate has been probated, and therefore, no file number has been assigned. The first scenario in which there has been no probate and no file number assigned is when a Decedent dies with no probate assets. For example, a Decedent may have transferred all of his assets to a revocable trust. An Inheritance Tax Return is still required, and tax may be owed.

Another scenario in which no file number has been assigned is when there is a delay in probating the Estate. This often can be the case when the original Will cannot be located and a hearing is required to admit a photocopy of the Will, when the Will is not self-proving and witnesses to the execution are being located, or in situations when the Decedent’s family has simply procrastinated in coming to your office to handle the Decedent’s affairs and Letters will not be granted in time to make the tax payment.

The Registers of Wills can assign a “miscellaneous file number,” under which the tax can be paid or a request for extension of time to file can be made to the Department of Revenue. In Philadelphia County, the request is made by writing to Room 180, asking for a miscellaneous file number, and paying the fee of $50.00 (fee as of August 2010). In Montgomery County, the requester completes an “Inheritance Tax Payment/Filing Form When Estate Not Probated,” available from the Register’s office. An original death certificate is required (although a copy may be sent until an original is obtained), as well as the fee of $35.00 (fee as of 2009). Since procedures vary by county and could change over time, the procedure should be ascertained at the time your specific problem arises.

Ethics Column

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

May I use social interactive media, including e-mail, blogging and chat rooms, to market my trusts and estates practice and solicit prospective clients?

Ethics Opinion 2010-6 issued recently by the Philadelphia Bar Association’s Professional Guidance Committee indicates that such use of the social media does not violate the Rules of Professional Conduct. The opinion is also a reminder that the Rules are not nearly as restrictive with respect to lawyer advertising as many attorneys continue to believe.

The answer to the inquiry can be found in Rule 7.3(b) that prohibits in-person solicitation of prospective clients with whom the attorney has no family or prior professional relationship. The Rule does permit solicitation by written communication, including targeted mail, because those methods are not considered “in-person.” However, telephonic and “real-time electronic communication”, which are considered a form of “in-person” communication, are not permitted.

The basis for the Rule is that in-person contacts may “subject the lay person to the private importuning of a trained advocate, in a direct, interpersonal encounter”, while written and certain other forms of communication will not.

The U.S. Supreme Court continued on Page 10
TAX UPDATE

By MARGERY J. SCHNEIDER, ESQ.
STERN AND EISENBERG, LLP

I. FEDERAL ESTATE TAX

Family Limited Partnerships

_Estate of Shurtz v. Commissioner_, T.C. Memo 2010-21 (February 3, 2010)

The Tax Court held that, because there was a bona fide sale for adequate and full consideration in money or money’s worth, the fair market value of a decedent’s limited partnership interest, not the fair market value of the underlying assets, was includable in the value of her gross estate for estate tax purposes. The Court also ruled that the marital deduction to which the estate is entitled was to be computed on the basis of the value of the limited partnership interest that passed to decedent’s husband.

Mrs. Shurtz, the decedent, had several purposes in forming Doulos L.P., the family limited partnership, in 1996: to shelter the family’s interest in its Mississippi timberland property from the risk of litigation, to restrict outsiders from acquiring an interest in the partner-

Ethics Column, continued

upheld the distinction in Shapero vs. Kentucky Bar Association, 486 U.S. 406 (1988), stating that “face-to-face solicitation” is “a practice ripe with possibilities for overreaching, invasion of privacy, the exercise of undue influence, and outright fraud.” The court also noted that written communications, unlike personal contacts, lend themselves to State regulation because they are visible and open to public scrutiny.

The Professional Guidance Committee, in reaching its favorable interpretation, did not ignore the prohibition against “real-time electronic communication” which was added to Rule 7.3 in 2005. Instead, employing the reasoning for which the classic “Philadelphia lawyer” is well known, it simply concluded that social media was not intended to be, and could not be included within, the definition of “real-time electronic communication”.

Pointing to the rationale in both the Rule and the Shapero case, the Committee said that emails, blogging and chat rooms are not akin to a “real-time electronic communication” device like the telephone because the interactive social media allow both (1) “the prospective client to “turn off” the soliciting lawyer and respond or not as he or she sees fit...” to the lawyer, and (2) the attorney’s retention of records of the communications required by Rule 7.2(b).

The Committee added a few cautionary notes. First, it warned that if the chat room enables communications in real-time voice, as a telephone does, it would probably constitute the prohibited form of “real-time electronic communication”. Second, the attorney must remain mindful of the other rules applicable to advertising, including Rules 7.1, 7.2 and 7.4. Finally, the opinion reminds us that attorneys using these means of solicitation must retain the contents for at least two years pursuant to Rule 7.2(b).

Of course, another caution is in order whenever using easy to use and informal electronic forms of communication: The attorney must be careful to avoid communicating in a manner that would either reveal confidential information about clients or develop an unintended lawyer-client relationship.

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

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Paul C. Heintz, Esquire Obermayer, Rebmann, Maxwell & Hippel LLP 1617 JFK Boulevard One Penn Center 19th Floor Philadelphia, PA 19103
Tax Update, continued

ship and to streamline the operation and management of the timber business. At the time of her death, Mrs. Shurtz and her husband each held a one-percent general partnership interest in Doulos L.P., Mrs. Shurtz held an 87.6 percent limited partnership interest, and her children and trusts for her grandchildren held the remaining 10.4 percent. The business was managed conscientiously, with the approval of Mrs. Shurtz required for every major decision.

Mrs. Shurtz’s estate plan, last revised in 1998, called for a revocable trust agreement to take effect upon her death. The goals of the trust were to minimize estate taxes, keep her interest in Doulos L.P. in the family, and ensure that the remainder of the estate (upon the death of the surviving spouse) passed into a charitable lead annuity trust. She died in January 2002. On her Federal Estate Tax return Mrs. Shurtz’s gross estate was valued at $8.8 million, with her limited partnership interest in Doulos L.P. valued at $6.1 million. $.3 million went to a unified credit trust and $7.7 million went to trusts qualifying for the marital deduction. No estate tax was paid.

The IRS claimed that the value of the assets contributed to Doulos L.P. were includable in the value of Mrs. Shurtz’s gross estate because she retained the control, use and benefit of the transferred assets under IRC §§ 2036 and/or 2035 (a). The IRS also contended that under IRC § 2056 (a), the value of her interest in Doulos L.P. should be used to determine the amount of the marital deduction. The Court ruled against the IRS, holding that although reducing estate taxes was a motivating factor in establishing the limited partnership, the bona fide sale exception to § 2036 (a) was applicable because the family limited partnership was created for “legitimate and significant nontax reasons” under Estate of Bongard v. Commissioner, 124 T.C. 95 (2005). The Court pointed to the following factors as “significant nontax reasons”: Doulos L.P. was expressly designed to limit the exposure of the ownership interests to possible lawsuits; the decedent and her husband were aware that the establishment of the limited partnership would facilitate the management of their timberland interests; and because a significant portion of the underlying assets (15.8 percent) required active management, management efficiency was promoted by the limited partnership structure.

The Court also found that full and adequate consideration was received under the factors listed in Bongard: each contributor received an interest in Doulos L.P. that was proportionate to the property contributed; the assets that were contributed were properly credited to each partner’s respective capital account; distributions from the limited partnership resulted in a negative adjustment in the distributive partner’s capital account; and there was a legitimate and significant nontax reason for the formation of Doulos L.P. (as discussed above).

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For these reasons, the Court held that the fair market value of Mrs. Shurtz's partnership interests, and not the fair market value of the contributed property, was includable in the value of her gross estate. The marital deduction to which the estate was entitled was to be calculated according to the value of the partnership interest that passed to her husband. No estate tax was due and there was no estate tax deficiency.

Qualified Family-Owned Business Interest Deduction

*Estate of Artall v. Commissioner,* 5th Cir., No. 09-60092 (January 28, 2010)

The U.S. Court of Appeals for the Fifth Circuit denied the taxpayer's appeal of a U.S. Tax court ruling that upheld the IRS's refusal to grant a qualified family-owned business interest (QFOBI) estate tax deduction. The taxpayers sought to include a debt interest in the meaning of “interest” in “Qualified Family Owned Business Interest” (QFOBI) under IRC § 2507, but the Fifth Circuit Court held that the term means only an equity or ownership interest.

Mary Artall formed Artall Farms LLC in 2001 to hold various assets and hold 50 percent of the company shares. In the course of that year she made eight unsecured loans to the company, totaling $343,000. She died the same year. Her children sought to make a total of $608,327 in QFOBI deductions on her estate tax return, because they constituted more than 50 percent of her gross estate. The QFOBI deductions included the loans and other business property. The IRS disallowed the deduction, claiming that loans receivable and the interest thereon were not deductible under IRC § 2507. When the deduction was disallowed, the QFOBI fell below the 50 percent threshold required for QFOBI deductions, causing a $247,101 tax deficiency.

The Fifth Circuit Court reasoned that, because under IRC § 2507(f)(1)(B) the IRS can recapture the tax savings (plus interest) of a QFOBI deduction if the heir who benefited from it disposes of the property within 10 years of the death of the decedent, debt interests should not be included in QFOBIs. As the Court stated, “debt interests ... are designed to be disposed of as the debtor repays the lender. It would be strange for Congress to open the QFOBI deduction to a class of ‘interests’ which would then require the beneficiary to repay the tax savings plus interest.”

*Ludwick v. Commissioner,* T.C. Memo. 2010-104; Nos. 3281-08, 3282-08 (May 10, 2010)

The Tax Court confirmed, with minor changes, the IRS's valuation of a couple’s respective conveyances to qualified personal residence trusts (QPRTs).

Andrew K. Ludwick and Worth Z. Ludwick, husband and wife, each owned a 50% interest in a Hawaii vacation home, worth $7.25 million, as tenants in common. In early 2005, they transferred their shares in the property to separate QPRTs, each claiming a 30% discount on their respective 2005 Federal gift tax returns. The IRS audited the returns and claimed that the discounts should be 15%. Later, at trial, the IRS argued that the discount should be no more than 11%.

Experts from both sides testified that the fair market value of an undivided interest in the property should take into account the impediments and restrictions on the ability to sell or liquidate the interest, such as the likelihood of partition and the subsequent marketability risk (the risk that the asset would not be able to be sold quickly at its fair market value). However, the experts disagreed on the amount of the resulting discount.

In a detailed analysis, the Court disagreed with the conclusions of both experts and determined that the appropriate valuation should take into account the time and costs of partition and the time and costs of selling the property if no partition was necessary. It arrived at a discount by estimating the present value of the weighted average of the two alternatives. In its calculations, it estimated the likelihood of partition, the length of time that the partition process would take and the costs involved. It also estimated the share of the operating costs to be borne by each party.

Estate Tax Inclusion Under Competing Marital Property Regimes

*Estate of Charania v. Shulman* (1st Circuit Court of Appeals, June 17, 2010)

The principal question presented in this appeal was whether, for federal estate tax purposes, 125,000 shares of stock in Citicorp, an American company, held in the name of the decedent, were community property under Belgium's marital property regime or separate property of the decedent under the United Kingdom's separate marital property regime.

Decedent and his wife were Belgian residents when the shares were acquired and when decedent died. They were UK citizens living in Uganda, which was under
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the marital regime of England, at the time they celebrated their marriage.

Applying England’s separate marital property regime, the tax court had held that all of the shares were includable in the decedent’s gross estate for federal estate tax purposes. *Estate of Chariotia v. Commissioner*, No. 16367-07, 133 T.C. No. 7. The Appeals Court affirmed the lower court’s ruling, stating that a change of marital domicile did not, in itself, alter the marital property regime under which the spouses acquired personal property during the marriage.

Both parties agreed that, for federal estate tax purposes, the whole law of the decedent’s domicile at the time of death controls the ownership of intangible personal property. They also agreed that a Belgian court would defer to the law of England, which was the country of the spouses’ common nationality. The question thus became whether marital property regime an English court would apply in determining the spouses’ property rights. The court looked to *De Nicolas v. Culier*, [1900] A.C. 21 (H.L.) as the only precedential case. In De Nicolas, the House of Lords applied the doctrine of immutability, which states that changing the marital domicile does not change the marital property regime that governs the spouses’ rights in personal property acquired during the marriage. For this reason the court held that the English separate property regime governed decedent’s property rights and that all shares were includable in decedent’s gross estate for federal tax purposes.

**Retained Possession or Enjoyment**

*In Re Estate of Stewart v. Commissioner*, No. 07-53370-ag, 2010 WL 3078783 (2d Cir. Aug. 9, 2010)

The Second Circuit Court of Appeals found that under IRC § 2036(a), the full value of a New York brownstone, a minority interest in which had been transferred to decedent’s son six months before her death, was not includable in decedent’s estate. The building was divided into residential and commercial portions. In 2000, the decedent, Margot Stewart, entered into an oral agreement with her son under which she deeded a 49% tenant-in-common interest to her son but retained all of the rental income and paid the expenses for the commercial portion. She resided in the residential portion with her son both before and after the transfer. The parties stipulated to a discount of 42.5% for lack of control and marketability for the divided property.

The Court ruled that there was an implied agreement between the mother and the son giving the mother the right to economic benefit from the commercial use of the property after the transfer, but that the mother retained no benefit from the residential portion. It found that there was an implied agreement concerning the commercial part of the property because the decedent enjoyed the substantial economic benefit from some part of it. But the Court refused to find that, based on the fact of co-occupancy alone, an implied agreement existed for the enjoyment of the residential portion of the property. It stated that two conditions were necessary in order to infer such an implied agreement: (a) the donor must have exclusive possession of the property and (b) possession must be withheld from the donee.

Finding that the Tax Court erred in finding that the terms of the implied agreement between Decedent and her son provided that Decedent would enjoy 100% of the substantial economic benefit of the son’s 49% undivided interest in the Manhattan property, the Court remanded the case to the Tax Court to determine the economic benefit to Decedent, which is amount includible in the Estate. It instructed the Tax Court to use the approach adopted in Rev. Rul. 79-109, in which “the portion of the property to be included in the gross estate is the portion that would be necessary to produce the income Decedent retained.”

Judge Livingston offered a strong dissent arguing that because the evidence shows that the parties to the transfer behaved the same way before and after the transfer, calling into question the existence of a “genuine post-transfer tenancy in common.” She was also protested that the majority had shifted the burden of proof from the taxpayer to the IRS.

**Credit for Tax Paid on Prior Transfers**

*In Re Estate of Le Caer*, 135 T.C. No. 14 (Sep. 6, 2010)

The Tax Court held that the credit for tax paid on prior transfers under IRC Section 2035 was limited to the portion of the estate tax paid by the estate of the first-to-die spouse that was attributable pro-rata to property included in the estate of the surviving spouse.

Lucien Le Caer died on January 19, 2004, with an estate of approximately $3.5 million. His wife, Marie, died two months later. Mr. and Mrs. Le Caer had executed a joint Family Trust Agreement and transferred property into it. Upon the death of the first spouse to die, the trust was to be divided into four shares. Share A would receive the separate property of the survivor; continued on Page 14
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Share B would be funded with the property of the first-to-die spouse and would qualify for a QTIP election under IRC Section 2056; Share C would receive any property disclaimed from Share B; Share D would consist of the remaining trust fund property.

Upon Mr. Le Caer’s death, Share B was funded in the amount of $1.9 million. The executor of his estate elected QTIP treatment for the Share with the exception of $495,000. The estate reported estate tax payable of $200,190 and Nevada “pick-up” tax of $24,810. A total of $225,000 was paid in federal and state death taxes. When Mrs. Le Caer’s estate filed Form 706, it claimed a credit for tax on prior transfers under IRC Section 2013 of $225,000. Her estate filed a protective QTIP election in 2007.

The Court concluded that IRS had correctly issued notices of deficiency for both estates. The IRS had disputed the $225,000 credit for prior transfers made by the estate of Mrs. Le Caer, arguing that the credit claimed by the estate ignored the applicable limits under IRC Sections 2013(b) and 2013(c). Under Section 2013(b) the credit is calculated as the value of the transferred property multiplied by the federal tax divided by the adjusted taxable estate. The Court ruled that the adjusted taxable estate (i.e., the denominator in this calculation) is reduced only by the amount of estate taxes paid and not by the applicable exclusion amount, as the estate claimed. The Court also ruled that under IRC Section 2013(c) the credit may not exceed the difference between the estate tax payable with respect to the entire estate and the estate tax payable with the transferred property removed from the estate.

The Court also disallowed the credit for the Nevada estate tax, because the statute permits a credit only for federal estate tax paid. The Court agreed that the Nevada tax was a “pick-up” estate tax but held that the fact that it was calculated by reference to the federal estate tax did not make it a federal estate tax.

The Court further held that, under Section 20.2013-4 of the Estate Tax Regulations, the value transferred to Mrs. Le Caer should not be the full $495,000, but only the value of the life estate portion of the $495,000.

The protective QTIP election made by the estate of Mrs. Le Caer was ruled ineffective because it was made three years after Mr. Le Caer’s death and was not made on Form 706.

Valuation

*In Re Estate of Jenson, 2010 T.C. Memo 182 (Aug. 10, 2010)*

In valuing the interest of Mrs. Jenson’s estate in a summer camp, the Tax Court ruled that present-value discounting should be used in applying a built-in long term capital gains (LTCG) discount to the value of the appreciated assets, using a dollar-for-dollar approach. The IRS had argued for the calculation of the built-in gains tax by comparing the discount for the built-in LTCG tax with the built-in LTCG tax exposure of 6 closed-end mutual funds. The Court, having evaluated the parties’ positions in view of *Eisenberg v. Comm’r*, 155 F.3d 50 (2d Cir. 1998) and the Court’s prior decisions, held that there was no viable method for avoiding the built-in LTCG tax for a hypothetical buyer of the estate’s stock. It stated that the present-value approach should be used because of the likelihood that the assets would appreciate and because of the concept of the time value of money.

Deduction for Administration Expenses

*In Re Estate of Stick, 2010 T.C. Memo 192 (U.S. Tax Court, Sep. 1, 2010)*

In a memorandum opinion, the Tax Court ruled that the estate is not entitled to an administration expense deduction for administration expense under IRC Section 2053 for interest on a loan incurred to pay its federal and state estate tax liabilities.

Henry H. Stick, the decedent, died on February 12, 2004. His will named his living trust as residual beneficiary of his estate. The trust borrowed $1.5 million from the family foundation to pay the estate’s federal and state estate taxes. The estate filed Form 706 in May, 2005. It reported a federal estate tax liability of $1,046,000 and funeral and administration expenses of $818,900, including $656,250 of interest on the loan. On its fiduciary income tax returns for 2004, 2005 and 2006, the trust claimed deductions for the interest on the loan to pay the estate tax.

The Court stated that, under Treas. Regs. Section 20.2053(a), which provides that estate tax deductions are limited to “expenses which are actually and necessarily incurred in the administration of the estate,” the estate could not demonstrate that it was necessary to borrow funds in order to meet its tax obligations. The Court determined that the estate had approximately $1,953,617 in liquid assets, which was an amount sufficient to pay its administrative expenses and federal and state estate taxes. Because the estate’s liquid assets exceeded its obligations, the Court denied the in-
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Interest deduction for the loan.

Deduction for State Tax Claim


The District Court of the Northern District of California granted the government’s motion for judgment on the pleadings, refusing to permit a deduction to the decedent’s estate based on the estimated cost of California state capital gains tax.

The decedent, Marshall Naify created a revocable trust in 1997. In late 1998 he formed the Mimosa Delaware Investment Corporation, whose offices were initially in Delaware and later in Reno, NV. He transferred notes contributeable stock of Telecommunications, Inc. to Mimosa in 1998, and the notes were converted into stock in 1999. The transfer was taxable for federal income tax purposes, but he hoped to avoid some of the California income taxes by making the corporation a non-California corporation.

Mr. Naify died on April 19, 2000. His estate filed his 1999 federal and California income tax returns, reporting $835 million in adjusted gross federal income and $629 million in California state income. The stated justification for the California adjustment was that the income in question was “realized by a corporation that is an S Corporation for federal income tax purposes but is a C Corporation for California income tax purposes.” The California Franchise Tax Board audited the return and contested the lower amount.

Mr. Naify’s estate filed a federal estate tax return in July, 2001, listing the decedent’s California income tax liability as $62 million. The estate had calculated this amount to be the likely value of California income tax payable on the stock conversion. In February, 2004, the estate and the state of California reached a $26 million settlement for the state income tax debt. The next month, the IRS allowed the $26 million deduction in the place of the $62 million deduction originally claimed by the estate.

The estate filed a claim for refund for $11 million, but the IRS denied the claim: The estate paid $12 million (for additional tax plus interest) and filed suit for a refund.

The Court concluded that the value of the disputed claim was not deductible because it was not “ascertainable with reasonable certainty,” on the date of death as is required under Treas. Regs. 20.2053-1(b)(3). Because, as the estate readily admitted, the Mimosa Corporation was created and managed in an attempt to qualify as a legitimate Nevada corporation and thereby avoid potential California taxation, it was not certain at the time of decedent’s death that the California tax would be assessed. The amount of California tax due was not determined until after decedent’s death, when the state return was audited and the audit resulted in the assessment of tax of exactly $62 million. The Court stated that if the Estate would have availed itself of the opportunity to notify the IRS during the audit that California had a claim that was not yet ascertainable with reasonable certainty, the estate would have been ultimately been allowed to deduct the value of the settlement.

Treas. Regs. 20.2053-1 also requires that the claim must be certain to be paid. The Court noted that the litigation with the California Franchise Tax Board was prolonged, with negotiations lasting seven years.

Therefore, the Court held as a matter of law that there was no certainty at the time of Mr. Naify’s death that any given amount would be paid.

Accuracy Penalty


The Tax Court ruled that a decedent’s estate was not liable for an accuracy-related penalty on account of negligence or disregard of the tax rules and regulations.

The decedent, Ralph Robinson, died in 2003. His son, James and daughter Carol were appointed co-executors of the estate. James, who was not a college graduate, had hired John Schlabach to provide estate planning for decedent, who suffered from Alzheimer’s disease during his lifetime. In 2002 Schlabach prepared a living trust for Ralph, with James and his sister Carol as co-trustees, and arranged for its funding. In 2003, Schlabach advised James and Carol that the value of six vacant residential lots could be excluded from Ralph’s estate if they were transferred to another trust. The trust was formed and the real estate was duly transferred.

One month after Ralph’s death, Schlabach advised the executors to transfer estate assets to a charitable trust in order to reduce the value of the taxable estate below the applicable exclusion amount. The executors accordingly formed the Robinson Foundation and transferred assets to it from the living trust.

Schlabach was hired to prepare the estate’s federal estate tax return. He did not include brokerage and bank accounts with assets total-
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...ing $64,077 on the return because James was unaware of them. The return also did not include the real estate held in the second trust. The estate claimed a charitable contribution deduction of $941,000 for transfers to the Robinson Foundation. The IRS issued a notice of deficiency and included $242,900 for the value of the real estate in decedent’s gross estate. It also disallowed the charitable contribution deduction. James conceded all issues in the notice of deficiency but contested the imposition of a 20% accuracy-related penalty under IRC Section 6662(a).

The Court held that James was not liable for the penalty under IRC Section 6664(c) because he could demonstrate that there was reasonable cause for the underpayment and that he had acted in good faith. There was reasonable cause for the underpayment because James had been unsophisticated in tax matters, reasonably believed that Schlabach was a competent tax advisor. He acted in good faith in believing that Schlabach was competent because Schlabach was an enrolled agent. Schlabach claimed to be certified in estate planning, Schlabach had prepared his income tax returns for many years with no problems and Schlabach claimed to be conservative. James did not know that Schlabach had been disbarred.

Transferee Liability


The Tax Court ruled that two steps were required to pay an estate tax deficiency that resulted from the disallowance of a deduction for the settlement payments they received as claims against the estate. Judith D. Upchurch, the deceased, married Tasker M. Upchurch. Each had children from a prior marriage. Tasker adopted Judith’s three children; Judith did not adopt Tasker’s children. Bruce and Carl. Tasker predeceased Judith. After he died, Judith executed a will directing that the interest in a house in Winthrop Harbor, Illinois, should be divided equally among the five children. After executing the will, she split the land on which the house was located into two parcels. By quitclaim deed, she conveyed one parcel to one of her sons and the other parcel to her daughter. The property was no longer part of her estate when she died on August 20, 2000.

Bruce and Carl brought suit against the executor of Judith’s estate seeking either to impose a constructive trust on the property or to obtain a declaratory judgment that the quitclaim deeds were invalid and made “in violation of a fiduciary relationship” that her children had to her. A settlement agreement was reached under which the estate paid $53,500 to Bruce and his attorney and $53,500 to Carl and his attorney. The payments were made directly to the attorney, who kept $17,833 of the proceeds from each claim.

On its estate tax return, Judith’s estate deducted the settlement payments as debts of the estate. The estate distributed all of its assets before receiving a final determination of its estate tax liability from the IRS. The IRS audited the return, disallowed the deduction and ultimately assessed a “failure to pay penalty” on Bruce and Carl as transferees of the estate.

The Tax Court decided four issues: (1) whether Bruce and Carl are transferees of estate property; (2) whether they are liable as transferees under Illinois state law or principles of equity; (3) whether the related attorney’s fees should be included in the total amounts for which they are liable; (4) whether they are liable for interest on the amounts transferred.

Concerning the first issue, the Court ruled that Bruce and Carl were liable for the tax as transferees “of property ... of a decedent” under IRC Section 6901(a)(1)(A)(ii). The estate was considered the transferor because the payments were made by the estate pursuant to the settlement agreement. Furthermore, they received the settlement payment as a substitute for the real property that was devised to them in the will. Concerning the second issue, the Court ruled that Bruce and Carl were liable for the additional tax as a matter of equity because under Illinois law, transferees of an estate are liable to the creditors of the estate. Concerning the third issue, the Court ruled that Bruce and Carl could not reduce their transferee liability by the one-third contingency fee paid to the attorney. Bruce and Carl controlled the litigation process and authorized payment to the attorney. Concerning the final issue, the Court held that interest accrued from the due date of the estate tax return.

Late Filing of Estate Tax


A New Jersey Federal District Court granted summary judgment in favor of the Estate, holding that IRS abused its discretion in denying a request for an extension to file, even though the request was made after the filing date for the return. The Court found that the Estate had good cause for filing a late estate tax return, and that the IRS cannot reject such a request without...
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considered the explanation provided by the Estate, the Court held that it could not justify its denial of the extension and had exercised its discretion in an arbitrary manner. The Court reasoned that there could be no possibility of judicial review, which is expressly authorized in the statute, if the IRS could not explain the denial.

The Court found that the circumstances, taken as a whole, surrounding the Estate’s tax return, constituted “good and sufficient cause” for the discretionary grant of an extension. First, noting that the filing is “under penalty of perjury,” the Court found that the inability of the heirs to agree on the assets to be included in the marital deduction indicated that the executor needed more time. The range of possible values was too wide for the Estate to come up with a reliable estimate. Second, because the Estate did not have possession of a critical part of the prenuptial agreement, it was impossible to calculate with accuracy the amount of the estimated tax payment. Third, the illiquidity of the assets prevented the Estate from paying estimated taxes until after the expiration of the filing period. Fourth, the poor communications between the decedent’s widow and the Estate made the calculation of the estate tax liability more complicated. Finally, the complexity of the Estate caused additional delay in the preparation of the return.

The Court held that the estate tax return must be treated as timely filed and the penalties and interest paid by the Estate must be refunded with interest.


Margaret Dickow, the decedent, died on January 15, 2003. Her executor requested and received an extension until April 15, 2004 to file the estate tax return. The executor filed a request for a second extension on Form 4768 in March, 2004 because it was waiting for an appraisal of a piece of real property that comprised a large part of the estate. The IRS claimed that the form was improperly filled out and refused to grant the request, but did not send notification of its refusal to the executor. The IRS issued two delinquency notices In September, 2004, the executor filed Form 706, which included a request for a refund of $337,139.41 of the $945,000 previously paid to the IRS. In September, 2007, the estate filed an amended Form 706, claiming a refund of an additional $239,768.48. The IRS denied the refund because the form was not filed within the required three year period under IRC Section 6511(a).

The District Court granted summary judgment to the IRS, based on its determination that the second requested extension did not permit a three-year look-back period for the amended Form 706 filed in 2007. It reasoned that, under Treas. Regs. Section 20.6081-1(b), the IRS did not have authority to grant a second six-month extension. The Court also ruled that the executor’s claim of equitable estoppel was without merit. In response to the executor’s argument that the failure of the IRS to notify him of the denial of the second extension amounted to “affirmative misconduct,” the Court stated that the doctrine of equitable estoppel does not apply to the IRS, whose

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“operating procedures do not create
rights in the taxpayer.”

Estate of Cederlaff v. U.S., No. 8:08-cv-02863 (D. Maryland, Sep. 9, 2010)

In a memorandum opinion, the U.S. District Court for the District of Maryland federal district Court granted the government’s motion for summary judgment and denied the decedent’s estate’s petition to waive penalties of $13,952 for the late filing of the estate tax return. It rejected the Estate’s argument that the timely determination and filing of the tax was made impossible because of the decedent’s complicated tax situation.

Dedecent died on August 15, 1999. A former IRS attorney was appointed personal representative of his estate. On May 15, 2000, the personal representative filed IRS Form 4768 to request a four-month extension and included a check for $30,000 representing the estate’s estimated tax liability. The IRS granted an automatic six-month extension. More than two months after the new deadline, the personal representative requested another extension and made an additional tax payment of $50,000, which was denied. The IRS instructed him to “file IRS Form 706 immediately.” The personal representative made an additional tax payment of $50,000. On October 31, 2001, the tax return was filed.

In a letter accompanying the return, the personal representative stated that late-filing penalties should be abated for four reasons: 1) Decedent had purchased a home in Las Vegas titled in his name and his brother’s name. The residence was involved in litigation; 2) Decedent resided in Maryland but his assets and financial records were scattered in Maryland, Oregon and Nevada; 3) Decedent was separated from his wife, who predeceased him. It was necessary to probate her estate to determine their total assets; 4) As of the extended due date of the return there were still unknown assets in the estate. The IRS refused to abate the penalties.

The District Court upheld the IRS’s decision to levy the penalties and ruled that the estate cannot establish reasonable cause for the late return. The Court stated that while IRC Section 6651(a)(1) and (a)(2) permit a waiver of the penalties for late filing if it “is due to reasonable cause and not due to willful neglect,” the late filing must be due to external circumstances, which it defines as circumstances beyond the personal representative’s control. It noted that the intent of the statutes is that the return that is filed must be “as complete as possible” and that it is acceptable to use incomplete information and estimated values in calculating the tax. It cited the payment of estimated tax payments as evidence of the fact that he had enough information to file a return. Furthermore, it held that although amended estate tax returns are not permitted, the personal representative could have filed supplemental information that changed the tax liability after the expiration of the extension period.

IRS Guidance


This Notice is intended to clarify the language in IRC §2511(c), which is in effect for transfers made after December 31, 2009 and before January 1, 2011. IRC §2511(c) states that “a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor’s spouse under [the grantor trust rules].” The effect of IRC §2511(c) is to extend the types of transfers subject to gift tax to include certain incomplete gifts, such that “each transfer made in 2010 to a trust that is not treated as wholly owned by the donor or the donor’s spouse under [the grantor trust rules] is considered to be a transfer by gift of the entire interest in the property under §2511(c).” The substantive gift tax law provisions of Chapter 12 of the Code in effect as of December 31, 2009, continue to apply to all transfers made both before and during 2010 to any other trust.

Private Letter Ruling 201022004 (June 4, 2010)

The IRS advised that a qualified terminal interest property (QTIP) election was null and void for the purposes of federal estate tax, gift tax and generation-skipping transfer tax. When the decedent’s executor filed a Federal Estate Tax return, the decedent’s adjusted taxable gifts were incorrectly listed and all of the assets destined for the proposed marital trust and residuary trust were listed on Schedule M. The executor thereby elected to treat all such property as qualified terminable interest property (QTIP), despite the fact that no estate tax would have been imposed whether or not the QTIP election was made. Since under Rev. Proc. 2001-38, 2001-1 C.B. 1335, a QTIP election is treated as null and void where the election is not necessary to reduce the estate tax liability to zero, the IRS disregards the QTIP election with respect to the residuary trust and treats it as null and void for purposes of IRC sections 2044, 2056(b)(7), 2516(a), and 2652.

II. GIFT TAX

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In a 2-1 decision, the Eighth Circuit affirmed a Tax Court ruling (130 T.C. No. 12 (2008)) that transfer restrictions in the Holman’s limited partnership agreement must be disregarded for Federal gift tax purposes because they did not serve bona fide business purposes and did not form a bona fide business arrangement as set forth by IRC § 2703(b)(1). The Eighth Circuit held that the Tax Court properly applied IRC § 2703 and had correctly applied a smaller lack-of-marketablety discount than the donors had originally claimed.

The majority opinion found that eligibility for the bona fide business exception depended on the taxpayer’s satisfaction of all three parts of the test in IRC § 2703(b):

1. The transfer restriction must represent a bona fide business arrangement;
2. The restriction must not be a device to transfer property to family members for less than adequate and full consideration; and
3. The terms must be comparable to similar arrangements entered into in an arms’ length transaction.

The Holmans had made gifts of their partnership interests, which consisted only of shares of Dell Inc. common stock. The court found that no business under IRC § 2703(b)(1) was carried on in this case because “the partnership...[held] only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy.” The limited partners had little, if any, ability to manage the underlying assets (i.e., the Dell stock) in the L.P. Citing Estate of Erickson v. Comm’r, 93 T.C.M. (CCH) 1175 (2007), the court stated that this arrangement was “a mere asset container,” which evinced no particular investment philosophy or special investing insights. The court further generalized that investment partnerships formed for the following purposes will not satisfy the bona fide business arrangement test: “estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education for the children.”

Finding that the Tax Court’s holding that the Holmans did not satisfy the first prong of the test, the Eighth Circuit did not address the other two parts of the test.

The Holmans argued that the Tax Court’s definition of “business arrangement” was too restrictive, effectively imposing a requirement that the underlying partnership be an actively managed company, an “operating business nexus.” The Eighth Circuit court disagreed with this conclusion, stating that the Holmans presented no evidence that showed that there was any business at all, i.e. nothing that could distinguish their arrangement from “the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash.”

The Eighth Circuit majority also affirmed the Tax Court’s approach to determining the marketability discount, i.e. that its approach was in part based on the consideration that a floor on the marketability discount could be determined by the economic interests of the remaining partners, who must be treated as economically rational actors. The remaining partners should be willing to purchase an interest for a value lying at some point between a pro rata share of the net asset value and the discounted price that a third party would be willing to pay. The Eighth Circuit held that this approach did not violate the hypothetical willing buyer/willing seller valuation standard.

The dissenting judge presented detailed arguments to demonstrate that the restrictions do satisfy the three-pronged test in IRC § 2703(b), and disagreed with the court’s reasoning concerning the marketability discount. He stated that the case should be remanded to the Tax Court in order to redetermine the marketability discount.


The U.S. District Court for the Southern District of Indiana ruled that transfers of interests in a limited liability company (LLC) from parents to children were not subject to the gift tax exclusion under IRC § 2503(b)(1) because they were transfers of future interests in property. The court ruled against the taxpayers on a motion for summary judgment.

John and Janice Fisher sought refund of the additional $625,986.00 in gift tax that was assessed in an audit of their 2000 through 2002 gift tax returns. During those years, they transferred a 4.762 percent membership interest in their family LLC to each of their seven children and claimed the annual gift tax exclusion. The LLC’s principal asset in those years was undeveloped land on Lake Michigan.
Tax Update, continued

gan.

The operating agreement of the LLC stated that the LLC was to be managed by an operating committee which appointed a general manager who, among his other duties, would control the amount and timing of distributions from the LLC. Mr. Fisher was appointed general manager and the operating committee was constituted of members of the family. The operating agreement also imposed transfer restrictions for all transfers to non-family members: any transfers made by LLC members of their rights to a share of the LLC’s profits and losses or their rights to receive distributions were subject to a right of first refusal held by the LLC.

Applying Reg. 25.2503-3(a) and citing Hackl v. Commissioner, 335 F.3d 664, 666 (7th Cir. 2003), the Court held that the Fisher’s gift did not confer a present interest on the donees because it did not give them an unrestricted right to the immediate use and enjoyment of the property.

The Fishers made three arguments that the gifts of LLC interests satisfied the present interest requirement: (1) the donees had an unrestricted right to receive distributions from proceeds of the sale of capital assets; (2) the donees had an unrestricted right to enjoy the land owned by the LLC; (3) the donees possessed the unrestricted right to unilaterally transfer their interests in the LLC. The Court disagreed with all three. Addressing the first argument, it held that the right to receive distributions was not unrestricted because it was contingent on several factors, including the discretion of the General Manager. It countered the second argument by stating that the right to use the land was the right to a non-pecuniary benefit that was not a substantial present economic benefit. It answered the third argument by pointing out that the LLC’s right of first refusal made it impossible for the children to realize a substantial economic benefit.

Pierre v. Commissioner, T.C. Memo 2010-106 (May 13, 2010)

In an opinion supplementing its prior opinion, Pierre v. Commissioner, No. 753-07 (August 24, 2009), the court held that the gift and sale transactions of interests in Pierre LLC should be collapsed and treated as disguised gifts of two undivided 50 percent interests under the step transaction doctrine, and that a slight reduction in the lack of control discount was appropriate.

Mrs. Pierre had worked with her attorney and financial advisor to develop a plan to transfer $4.25 million in cash and marketable securities to the single-member Pierre LLC. Her goals in creating the entity were to minimize taxes and to provide support for her son and granddaughter. Twelve days after funding the LLC, she transferred her entire interest in the LLC to trusts for her son and granddaughter through a combination of gifts and sales, each trust receiving a 50% interest. She gifted a 9.5 percent membership interest in the LLC to each of the trusts. The amount of the gifts was determined by appraisal to be the largest gift she could make without incurring gift tax. She sold each trust a 40.5 percent membership interest in exchange for a promissory note secured by the membership interest.

Accordingly, the Court found that Mrs. Pierre’s motives for structuring the transfers were primarily tax-motivated, and that for each of the two 50 percent interests, the amount by which the interest exceeded the value of the promissory note was to be considered a gift to the trust.

The Court determined that the lack of control (minority) discount should be determined by an analysis of the rights and restrictions of the two 50 percent blocks gifted to the trusts instead of the 9.5 percent interests that were originally reported. The Court reduced the discount from 10 percent to 8 percent because, unlike a 9.5 percent ownership interest, a 50 percent interest enabled a member to prevent the appointment of a new manager.


The plaintiff, Craig Breakiron, was successful in winning permission to rescind his disclaimers of two QPRTs and thereby avoid $2.3 million in gift tax. The U.S. District Court in the District of Massachusetts held that he was entitled to the

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rescission under applicable state law (Massachusetts) because he had executed the disclaimers in the mistaken belief that they would allow him to achieve his goal of minimizing taxes.

The plaintiff and his sister were remaindermen who succeeded to their parents’ property at the conclusion of two QPRTS. At the end of the ten-year term of the QPRTS, the property passed to them as tenants in common. His attorney incorrectly advised him that he could execute a qualified disclaimer within nine months after the expiration of the term of the QPRT in order to transfer the property to his sister without gift tax. Because the disclaimers were not executed in time to be qualified disclaimers under IRC Section 2518, the IRS sought to impose gift taxes.

The plaintiff brought an action to rescind the disclaimers under the Massachusetts statute that provides that a written instrument may be reformed or rescinded in equity on the grounds of mistake that frustrated the purpose of the transfer when there is “full, clear, and decisive proof” of the mistake.

The Court, applying state law, ruled in favor of the plaintiff and reformed the disclaimers “nunc pro tunc” to treat them as if they had never been executed and the gift had never been made. Reasoning that no federal gift tax liability had accrued because there was no completed gift, the Court held that no gift taxes were payable. It ruled in this way despite its concern that parties may enter into collusive rescission agreements whose goal is avoiding gift taxes. The Court was persuaded that there was no collusion here by the facts that (a) the rescission action was heard by a federal Court, not a state Court, and (b) the IRS was a party to the action, thus eliminating the risk of collusion by the private parties.

**IRS Guidance**

Private Letter Rulings 201003017 and 201013018 (both April 2, 2010)

The IRS ruled that trusts will not lose their GST tax exemption or become liable for federal gift tax upon the implementation of settlement agreements between the families of the settlors’ deceased son and living son concerning trusts created for the benefit of the sons, their families and a charity.

Private Letter Ruling 201022004 (June 4, 2010)

See discussion under Federal Estate Tax.

Private Letter Ruling 201025021 (June 25, 2010)

The IRS allowed a taxpayer 60 days to make a late QTIP election on a gift tax return for an inter vivos QTIP trust. The trust instrument had explicitly provided “that Grantor intends, to the extent that QTIP elections are made on the gift tax returns with respect to Trust, to be entitled to the maximum federal gift tax marital deduction.” The gift tax return was timely filed, but the taxpayer’s attorney had failed to make the QTIP election on the return. The IRS stated that under Treas. Regs. Section 301.9100-1(c) relief can be granted when the taxpayer can provide evidence of having acted reasonably and in good faith. Here, the taxpayer was found to have so acted when she relied on the qualified tax professional whom she had hired to file a gift tax return.

Chief Counsel Advice 201020009 (May 21, 2010)

The IRS held that the amount of gift tax paid by a non-resident alien (NRA) on gifts made within three years of death was not brought into the NRA’s gross estate under IRC Section 2104(b). The Chief Counsel interpreted Section 2104(b)’s reference to “property transferred by the decedent within the meaning of IRC Sections 2035 through 2038” to mean property transferred gratuitously by an NRA. Because the gift tax paid by an NRA cannot be considered a gratuitous transfer, the Chief Counsel determined that it should not be brought into the NRA’s gross estate under Section 2104(b).

Chief Counsel Advice 201024059 (June 18, 2010)

In e-mailed advice, the Chief Counsel of the IRS stated that an exception will be made to the three-year period of limitations on gift tax and that gift tax can therefore be assessed “at any time” if the donor provides inadequate information on the method used to value closely held stock or the discounts taken in valuing the stock.

Chief Counsel Advice 201030029 (Aug. 2, 2010)

The IRS ruled that the taxpayer who is concerned that a gift was not “adequately disclosed” on the gift tax return under Treas. Regs. Section 301.6501(c)-1(f)(2) can file an amended gift tax return including the additional information he or she believes to be necessary. The IRS will then decide whether to audit the return. If a gift is not “adequately disclosed” on a gift tax return, tax can be imposed on the gift at any time under IRC Section 6501(c)(9). A gift is adequately disclosed if the return includes the trust’s tax ID and

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Under the statutory grandfather exemption codified in IRC § 2601, the GSTT is not imposed on a generation-skipping transfer under a trust that was irrevocable on September 25, 1985 -- but only if the transfer was not made from corpus “added” to the trust after that date. The term “added” is not defined in the statute, but Treasury Regulation 26.2601-1(b) states that the release, exercise or lapse of a power of appointment after 9/25/85, if it is a taxable transfer under Chapters 11 or 12 of the IRC, is considered to be a withdrawal of trust property and its retransfer to the trust. Therefore, a trust that would otherwise be grandfathered from GSTT would be subject to the current GSTT rules if such a release, exercise, or lapse of a power of appointment takes place.

The Estate made two unsuccessful arguments: first, that the concept of “constructive addition” in Treasury Regulation 26.2601-1(b), does not come within the scope of IRC § 2601, and second, that the word “added” should be interpreted as applying only to transfers to corpus from an outside source, which would make it inapplicable to this case. The Court rejected both arguments, countering the first by stating that the ambiguity inherent in the statute was adequately resolved by the “constructive addition” provision adopted in the 1999 Treasury Regulation and that the “constructive addition” provision achieves the purpose of the GSTT, which is to tax generation-skipping transfers similarly to the manner in which single-generation transfers are taxed, and countering the second by holding that the grandfathering exemption did not apply because the trust assets remained in the trust after the lapse of Louise’s GPOA, and that the lapse subjected them to GSTT.

IRS Guidance

Private Letter Rulings 201011002 and 201011008 (both issued March 19, 2010)

The IRS ruled that no gift tax or change of generation skipping tax status is triggered when three grandfathered trusts created for the benefit of the settlor’s children and their respective families are divided and the divided trusts are later merged.

Private Letter Rulings 20103017 and 20103018 (both April 2, 2010)

See discussion in Federal Gift Tax section.

Private Letter Ruling 201022004 (June 4, 2010)

See discussion in Federal Estate Tax section.

Private Letter Ruling 201026018 (July 2, 2010)

The IRS ruled that the division of a GST trust into subtrusts for the son and daughter of the grantor before the death of the surviving spouse of the grantor, who holds a life interest in the trust, will not alter the GSTT inclusion ratio of the trust or the successor subtrusts. The two children, who are the remainder beneficiaries, desired to divide the trust because of their different investment strategies. The IRS also ruled that the division of the trust would not cause any portion of the assets to be included in the gross estate of the beneficiaries of the son’s trust or daughter’s trust under IRC Sections 2035 through 2038.

Private Letter Rulings 201026014, 201026024, 201026025, 201026029, 201026027 (all issued July 2, 2010)
Tax Update, continued

In this series of Private Letter Rulings, the IRS held that a proposed judicial construction permitting beneficiaries of a trust containing a spendthrift clause to make sales of their remainder interests will not affect the GST tax-exempt status of the trust because no beneficial interests in the trust would be shifted to a lower generation and the time for vesting of any beneficial interest would not be extended beyond the period stated in the original trust. Because the trust in question became irrevocable before September 25, 1985, it is not subject to GST tax.

Private Letter Ruling 201029011 (July 23, 2010)

The IRS ruled that a decedent’s exercise of a power of appointment over a GST-exempt grandfathered trust established in a will prior to 9/1/85 did not trigger inclusion under IRC Section 2041(a)(3). The decedent exercised her power of appointment by directing that the trust assets should be distributed to a separate trust that was to be divided into shares which were to be allocated to trusts for the benefit of each of her children. Each child was granted a limited power of appointment to appoint the property in his or her trust to descendants of decedent and her husband who were living at the time of her death. Each of the children’s trusts was to terminate 21 years after the death of the last survivor of the class of descendants of decedent’s father who were living as of the date of the death of the father.

Under IRC Section 2041(a)(3), if a decedent exercises a power of appointment by creating a new power of appointment that could defer the vesting of interests in property for a period that can be determined without regard to the date of the creation of the original power, the value of property subject to the original power of appointment is includable in the decedent’s gross estate.

Here, the original power of appointment was created on the date of the death of the father of decedent, the rule against perpetuities (RAP) period for the property appointed in the second power of appointment was determined with respect to that date, and the exercise of neither of the powers of appointment could postpone the vesting of any property interest beyond the RAP period. As a result, IRC Section 2041(a)(3) was not triggered.

The IRS also determined that the appointed property would keep its GST-grandfathered status under Treas. Regs. Section 26.2601-1(b)(1) for the same reasons that IRC Section 2041(a)(3) did not apply.

IV. GENERAL IRS GUIDANCE


This new page on the IRS website contains a list of questions and answers concerning the current uncertain status of the estate tax, gift tax and GST tax for 2010 and 2011. After providing brief answers to the questions, in numerous cases it directs the reader to consult his/her tax advisor for more information.

V. GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2011 REVENUE PROPOSALS (THE “GREEN BOOK”), Department of the Treasury (February, 2010)

The 2011 Green Book, which contains President Obama’s budget proposals for fiscal year 2011, includes three revenue proposals with implications for the federal estate tax and gift tax. These proposals are repeated word for word from the 2010 Green Book (published in May 2010). The President’s budget projections assume that Congress will extend the estate and gift taxes in effect for calendar year 2009 (top rate of 45 percent and exemption amount of $3.5 million). (p. 147)

1. Modify Estate and Gift Tax Valuation and Make Other Reforms: Require Consistency in Value for Transfer and Income Tax Purposes. (pp. 122-123)

The goals of the proposed provision are consistency and the proper reporting of basis. The recipient’s basis of property acquired from a decedent under IRC § 1014 would be equal to the value of the property reported for estate tax purposes. The recipient’s basis of property gifted by a donor during his/her lifetime would be the donor’s basis as determined under IRC § 1015. In no event could the recipient’s basis be greater than the value (after adjustments) of the property as determined for estate or gift tax purposes. The executor of a decedent’s estate and the donor of lifetime gift would be required to provide the necessary information concerning basis to both the recipient and the IRS.

Regulations would be promulgated for circumstances such as when no estate tax or gift tax return is required to be filed, the surviving joint tenant or other recipient has more accurate basis information than the executor, or adjustments to the reported value are made subsequent to the filing of the estate or gift tax return.

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2. Modify Rules on Valuation Discounts. (pp. 124-125)

The Obama Administration recognizes that judicial decisions and new statutes have recharacterized the restrictions in IRC § 2704(b) on discounts in the value of transferred interests in family-controlled entities, making the restrictions inapplicable in many situations, and that new arrangements have been implemented that circumvent the application of IRC § 2704. This proposal would supplement IRC § 2704 by classifying as “disregarded restrictions” any restriction used in the valuation of an interest in a family-controlled entity transferred to a family member that could lapse or be removed by the transferor or his/her family after the transfer.

Regulations would specify the new assumptions to be used in valuing the transferred interests. “Disregarded restrictions” would include: 1) limitations on a transferee’s right to liquidate his/her interest that are more restrictive than those specified in the regulations; 2) limitations on a transferee’s right to be admitted as a full partner or equity interest holder. The regulations would also identify certain interests held by charities or other non-family members that would be deemed to be held by the family.

This proposal would be applicable to transfers made after October 8, 1990 (the effective date of § 2704).

3. Require Minimum Term for Grantor Retained Annuity Trusts. (p. 126)

This proposal would require that GRATs created after the date of enactment have a minimum term of ten years. Requiring such a long minimum term would increase the risk that the grantor would die during the GRAT term, which would mean that the trust assets needed to produce the retained annuity would be included in the grantor’s gross estate for estate tax purposes.

VI. NEW JERSEY INHERITANCE AND ESTATE TAXES

Estate of Taylor v. Director, Div. of Taxation, No. 011684-2009, N.J. Tax Court (February 24, 2010)

The New Jersey Tax Court confirmed the denial by the New Jersey Division of Taxation of plaintiff’s claim for refund of estimated inheritance tax payment. The Court held that the request for refund, which was made approximately five years after the date of payment, was untimely under N.J.S.A. 54:35-10. The statute provides that refunds of erroneous tax payments may be made if they are claimed within three years from the date of the payment of the taxes.

Estate of Ehringer v. Director, Division of Taxation, No. A-4982-08T3, Superior Court of New Jersey, Appellate Division (March 16, 2010)

The Appellate Court affirmed the judgment of the Tax Court made on April 9, 2009, which denied the claim of the Estate of Frank J. Ehringer (the “Estate”) for a refund of New Jersey Estate Taxes.

Under New Jersey law, an estate must file a protective claim for a refund of New Jersey estate tax within three years in order to preserve its right to claim a refund based on deductible expenses that the estate is likely to incur in litigation beyond the three-year period.

Frank J. Ehringer died on May 21, 2003. His estate paid es-
tate taxes of $128,000 on February 2004. After informing the Division of Taxation that the estate tax return would be delayed, the Estate filed its estate tax return in February, 2006, and received a refund of $32,419.66. In January, 2008, the Estate filed an amended state estate tax return, claiming an additional refund of $29,303.04 based on an audit of its federal estate tax return. The Division of Taxation refused to issue the refund.

The Estate appealed this decision, arguing that it was inequitable because the claim was related to costs incurred in litigation concerning the Estate that had taken four years to complete. The Estate stated that there was no way that these litigation costs could have been reasonably estimated during the three years allowed by law for a refund claim, that it had preserved its right to a refund by sending several letters to the Division of Taxation, and that the state should take into account factors beyond the Estate’s control, such as “lengthy delays on the part of the federal government in resolving federal tax issues.” The Division of Taxation denied the appeal but granted a refund for the balance remaining of the refund sought when the original return was filed. The Tax Court affirmed the reasoning of the decision of the Division of Taxation, holding that the Estate’s refund claim was not filed by the statutory deadline and the statute of limitations was not equitably tolled.
A common estate planning technique used by property owners in the Marcellus Shale ("Marcellus") area has been to separate the up front lease payment received for the surface real estate from the subsurface mineral estate. Oftentimes, the royalty rights are placed into a limited liability company (LLC) or a family limited partnership (FLP). The membership interest in the LLC or the limited partnership interest in the FLP is then transferred (gifted or sold) to future generations.

The appraisal of the subsurface and mineral estate (gas royalty rights) relating to the Marcellus is a challenging task. The valuation approach typically used is the income approach: determining the present value of the anticipated royalty revenue stream.

This method is based on a number of variables, including: the estimated ultimate recovery ("EUR") of the amount of gas in place; the timing of when, if ever, the wells will be drilled and producing, and the risk or uncertainty associated with the above. This uncertainty is reflected in the timing of when it is assumed that royalties will be generated and in the rate of return that a potential buyer of these royalty rights would require.

Once these factors are determined and the risk properly assessed, a present value is calculated. Properly employing this approach generally requires the expertise and judgment of engineers, geologists and valuation experts. The following article will discuss the valuation of the gas royalty rights and the factors impacting value.

Production

The Marcellus was known to contain gas but its potential is now being realized since the horizontal drilling technique that allows following the contours of the shale bed was perfected. As recently as 2005 there was very little interest in leasing properties for the Marcellus gas production. It was not considered to be an important gas resource and a technology for tapping it had not been demonstrated. At that time there was a high level of uncertainty and the signing bonuses were a few dollars per acre. Today, signing bonuses can be over $5,500 per acre and gas royalty rights can be as high as 20 percent. While the up-front bonuses can be significant, the royalty rights can be much greater.

Not all land in the Marcellus Shale region is equally productive. The richness of the Marcellus is dependent on more than a dozen geological parameters including thickness, depth of burial, degree of faulting, porosity, permeability, total organic carbon, thermal maturity, gas composition, gas pressure, clay content, silica content, water saturation, and other less important factors. Taken together, these parameters may be integrated in the EUR which is provided by an geologist.

A high EUR does not guarantee the receipt of high royalties. Before the gas companies can even start physical preparations for drilling, they must obtain permission from one of the river basin commissions ("RBC"). To date, there has been much drilling activity in the Susquehanna River Basin but none in the Delaware River Basin (which has, in effect, put a moratorium on all natural gas drilling in the watershed until it adopts regulations that specifically address this activity). These agencies regulate not only where gas companies can get water for hydraulic fracturing ("fracking") and how much they can take from each source, but also the conveyance, transport and storage of water.

Drillers have to shatter the Marcellus to release the gas trapped in the rock. This is accomplished through fracking, fracturing the shale with high pressure injections of water, chemicals and sand. The sand is pushed into tiny fissures in the shale allowing the gas to escape. The sand lodges in the cracks to keep the fissures open. A frack typically includes additives, such as surfactants to keep the sand suspended, polymer friction reducers that speed the mixture and biocides to prevent bacteria.

The drilling and development of each production well uses, on average, between 4 and 7 million gallons of water. The RBCs play an important role as they regulate water withdrawals and consumptive

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Valuation of Marcellus Shale Natural Gas Royalty Rights, continued

water uses in their respective areas. The RBCs require natural gas companies to monitor their water use on each drilling pad on a daily basis and provide quarterly reports of water usage.

Most gas leases permit the pooling and/or unitization of the leased tracts for purposes of applications for well permits and efficient operation of a producing reservoir. Until recently, such units were limited to 640 acres (one square mile). Technological advances have increased the horizontal drilling distance and unit sizes have increased accordingly. A unit as large as 880 acres has been reported. The owners of the mineral rights in the unit will get their pro rata share of the royalties generated by the production in that unit. E.g. The owner of the mineral rights connected to 88 acres in an 880 acre unit will be entitled to royalties on 10 percent of the production in that unit.

Multiple horizontal wells can be drilled from a single pad which may encompass four to five acres. This helps reduce the impact of drilling on the surface land while providing access to natural gas production from 200 to 400 acres.

Timing

A question having a significant impact on the value of the gas royalty rights is: when will royalties be generated? This is dependent on the drilling activity (or lack thereof) in the area, the time requirements to apply for drilling permits, have permits issued, begin drilling, and complete drilling. Also, before a well can begin production it must be tied into a gas transportation system through a gathering system pipeline. Hence, the location of the property to the pipeline can impact timing.

A unit is typically developed over a period of time. Generally, operators will first drill one or two exploratory wells. After analyzing the production from these wells, among other factors, the operator will determine whether or not additional drilling is feasible. Even if operators decide to continue to develop the site, additional drilling may not commence until the necessary gathering system pipeline is in place. Considering the time required to apply for permits, have permits issued and complete a well, subsequent wells may be drilled every two months or so.

Natural gas production is not evenly distributed over the life of the well. Decline curve models predict the rate of flow as a function of time, initial production rate, and a parameter that has the units of inverse time. Because there is limited public data to define a Marcellus decline curve precisely, initial information is based on data available in the public domain. It is estimated that the best fit curve for Marcellus wells follow a power law rate decline. Under this curve, it is estimated that approximately 3.1 percent of the total production will be in the first month of drilling. By the 12th month, it drops down to 0.7 percent and continues declining thereafter. While a well may produce for 50 years, its economic life may be 25 to 30 years.

Risk Factors

There are numerous uncertainties surrounding the potential royalties that a property might generate. Some uncertainties relate to the property itself. Others are more market driven. All have some impact on value. Some of the more pertinent factors are discussed below:

- The speculative nature of the subsurface and mineral estate.

- Inherent uncertainties in interpreting engineering data; there is substantial uncertainty in projecting future production rates. No one can measure underground accumulations of natural gas in an exact way. Accordingly, natural gas reserve engineering requires subjective estimations of those accumulations.

- There is no guarantee that the drilled wells will yield the EUR.

- Operating hazards, including mechanical, technological and/or other operational problems.

- Delays or cancellations of drilling operations for a variety of reasons; e.g. EOG Resources Inc. was temporarily banned from drilling after a recent well blow out (the suspension was since partially lifted).

- The potential that laws are enacted, such as the FRAC Act, that make fracking illegal or commercially impractical. Without fracking, “unconventional” shale plays such as the Marcellus would not be feasible.

- Change in regulations as the RBCs continue to amend their regulations to address concerns regarding adverse impacts to water resources.

- Volatility in natural gas prices. The average U.S. wellhead price (wholesale/spot) per thousand cubic feet ("mcf") dropped from $7.26 in 2005 to $6.38 in 2007, peaked at $8.08 in 2008 and reached a period low of $3.72 in 2009. The price dropped from $5.14 per mcf in January 2010 to $3.92 in April continued on Page 27
before it rebounded to $4.04 in May. Currently, the average U.S. wellhead price is estimated to average $4.27 and $4.90 in 2010 and 2011, respectively. Rising prices spur interest. It requires over 4 to 7 million gallons of water and costs nearly $4 million to drill one well. Hence, as natural gas prices drop, drilling becomes less economically feasible.

- Changes in governmental regulations or taxation; Pennsylvania continues to discuss the imposition of a 5 percent severance tax on natural gas production; this tax would be deducted from the royalty payments.

All of the above are taken into consideration in selecting the rate of return that an investor would require.

Publicly-traded oil and gas companies must use a standardized measure of discounted future net cash flows, including a “safe-harbor” discount rate of 10 percent, to value reserves (Accounting Standards Topic 932). This is done to ensure comparability among companies. However, the 10 percent discount rate does not adequately reflect market risks and is oftentimes lower than the publicly-traded oil and gas companies’ weighted average cost of capital (range from 12.5 percent to 17.5 percent). In addition to the required rate of return, the timing of the cash flows can have a major impact on value.

In summary, numerous variables impact the value of the gas royalty rights. Similar-sized properties can have significantly different values attributed to these rights. A defendable valuation generally requires the expertise and judgement of engineers, geologists and valuation experts.
The PEPC invites the Philadelphia Bar Association Probate and Trust Law Section to join our Council for membership and programming!

November Luncheon Program
November 16, 2010
11:45 a.m. - 1:45 p.m.
The Union League
140 S. Broad Street, Philadelphia, PA
Topic: "FLP Planning Update and Practical Planning Considerations"
Speaker: Stephen R. Akers

Holiday Celebration
December 6, 2010
5:30 p.m. - 7:30 p.m.
The Down Town Club
150 S. Independence Mall West. Philadelphia, PA

January Luncheon Program
January 18, 2011
11:45 a.m. - 1:45 p.m.
The Union League
140 S. Broad Street, Philadelphia, PA
Speaker: Blanche Lark Christerson

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