Report of the Chair

By NINA STRYKER
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As I write this Column in September, I am pleased to report that the work of the Section and its many committees continues to be truly impressive. We have witnessed two excellent educational programs, the March 1st program titled “The Challenges of Representing a Client with Diminished Capacity” and the June 7th program titled “Family Limited Partnership Planning and Litigation Strategies.” Another program is schedule for October 4, “Advising a Charitably-Minded Client.” Congratulations to Aaron Fox and the Education Committee for producing such wonderful, informative programs.

The new Business Planning Committee has had two well attended meetings and is planning further meetings for October and November with topics to be announced. Please read the email blasts on our list server for further information. Dennis Reardon would be pleased to hear from you if you have suggestions for discussion, or topics for the group.

After a modest hiatus - our Elder Law Committee is re-convening and will now be known as the Elder Law and Guardianship Committee. The new co-chairs will be Rise Newman and Nancy Lewis. The committee’s initial meeting, on September 22nd, included an organizational component and a presentation by Lou Horvath of Intervention Associations. Lou has long been a gracious and faithful sponsor of our Section and annual meeting. Our thanks to Lou for volunteering to address this group, offer comments, and supporting our Section!

As many of you know, one of my goals as Chair is to expand the Section’s efforts to serve our membership, and particularly those younger practitioners and/or those who are new to our practice. For our Section area to thrive in the future, we need to attract new members to the Section (and of course our practice area), and to have them actively engaged. Alison Altman Gross has generously volunteered, as Young Lawyers liaison, to assist with the formation of lunch discussion groups and happy hours. In addition, the Young

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Lawyers Division in conjunction with the Probate Section is presenting a program at the Bench-Bar conference this year. This is a terrific start, but we cannot be satisfied with those efforts alone.

I have heard many practitioners express concern about the future of our practice, and comment that we may have trouble attracting new members of the Bar to the trust and estates field. From my personal observation, it seems that fewer people are intrigued by our practice area, or have been encouraged to explore the breadth and options within our practice area. Perhaps there is a perception that T&E work is mundane and boring. The practice area can also have a rather steep learning curve. However, as most of us know, the practice is as varied and challenging as the families and situations with which we are confronted. Sometimes the issues provide more drama than a good TV mini-series! This is truly an area of the law in which we can assist families in resolving those latent sibling rivalries and long buried animosities. I would challenge each of us to search for opportunities to identify and encourage those individuals who may one day take over the leadership of our committees and Section. This trust and estates field can provide a vital and thriving practice, and will continue to be necessary as long as there are families who need planning to care for their own families, to settle their estates, provide for continuation of their business interests or charitable ventures, or if necessary, to litigate their issues. If you have thoughts on ways in which we can assist our members, encourage new members or serve, the Officers of the Section and I would be pleased to hear from you.

The Use of Trusts in the Asset Protection Context: How to Help Clients Plan so that a Beneficiary Can Have His Cake and Keep His Creditors from Eating It Too

By JOHN A. TERRILL, II, AND JILL R. FOWLER HECKSCHER, TEILLON, TERRILL & SAGER, P.C.

For some clients, the primary reason to include trusts as part of their overall estate plan is to take advantage of tax planning opportunities. Other clients, however, value the asset protection that can be afforded by properly-drafted trusts regardless of or in addition to the tax planning benefits. If the federal estate tax exclusion remains at five million dollars (an amount that will be indexed for inflation), and portability of the exclusion remains a feature of the federal estate tax system, in time asset protection may become the over-arching reason why many of our clients will choose to include trusts in their planning rather than outright distributions of property.

When we counsel clients about the use of trusts in the context of asset protection it is important to draw a distinction between trusts created by a client for someone else (for example, by a parent for a child) which we will refer to as “third party trusts,” and trusts that a client creates for his or her own benefit, referred to as “self-settled trusts.” This article will focus primarily on Pennsylvania law with respect to third party trusts, and will touch on Delaware law when discussing self-settled trusts, because of Delaware’s proximity to Pennsylvania (although there are a number of other jurisdictions that have enacted statutes intended to allow a settlor to gain creditor protection by creating and funding self-settled trusts that meet certain requirements).

THIRD PARTY TRUSTS

Spendthrift Provisions. The asset protection afforded by third party trusts in Pennsylvania and in other jurisdictions generally stems primarily from the inclusion in such trusts of a “spendthrift” provision.

In its simplest form, a spendthrift provision provides that a beneficiary may not sell or transfer his or her interest in the trust. As a general matter, if the beneficiary is unable to reach the assets, the beneficiary’s creditors cannot reach the assets either. Put another way, a creditor cannot have greater rights in the trust property than the beneficiary. A typical spendthrift provision might read as follows:

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The principal and income hereunder shall not be subject to: (1) attachment for any debt, contract or engagement of any beneficiary; (2) any legal process against any beneficiary; or (3) assignment, transfer or anticipation by any beneficiary.

Until 2006, the extent to which a creditor could reach the beneficiary’s interest in a third-party trust governed by Pennsylvania law and containing a spendthrift provision was based in part by a provision of the Probate Estate and Fiduciary Code and in part by case law. As a result of the enactment of the Uniform Trust Act (referred to herein as the “UTA”), Pennsylvania now has a fairly clear statutory roadmap controlling the rights of a beneficiary’s creditors to access assets in a third-party trust.

The UTA contains several provisions which bear on this analysis. Section 7741 provides as follows:

A judgment creditor or assignee of the beneficiary may reach the beneficiary’s interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means to the extent the beneficiary’s interest is not subject to a spendthrift provision.

The impact of this provision is self-evident; in the absence of a spendthrift provision, a beneficiary’s creditors and assignees have very broad rights to access assets in a third-party trust.

Section 7742 of the UTA sets forth both the requirements for creating a spendthrift provision and its effect. It is important to note that Section 7742 provides that a spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary’s interest; accordingly, although the statute requires that a third-party trust need only state that a beneficiary’s interest is subject to a “spendthrift” provision in order to be effective, the better course is to include language that makes clear that the beneficiary does not have the power to give away or transfer his or her interest in the third-party trust. Section 7742 further provides that “A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision. Except as otherwise provided in this subchapter, a creditor or assignee of the beneficiary of a spendthrift trust may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.”

Discretionary Distributions versus Mandatory Distributions. The extent of the creditor protection provided by a third-party trust is not only impacted by the presence or absence of a spendthrift provision, but also by the “substantive” terms of the trust. Generally speaking, a third-party trust that provides a trustee with decision-making authority or “discretion” with respect

1 See Sproul-Bolton v. Sproul-Bolton, 117 A.2d 688 (Pa. 1955). See e.g., 20 PA. CONS. STAT. ANN. § 6112 (providing that “[i]ncome of a trust subject to spendthrift or similar provisions shall nevertheless be liable for the support of anyone whom the income beneficiary shall be under a legal duty to support.”); See also Lippincott v. Lippincott 37 A.2d 741 (Pa. 1944)(holding that a predecessor to section 6112 applied only to support due an income beneficiary’s existing family and not to alimony due an ex-wife). In re Ware Trust, 814 A.2d 725 (Pa. Super. Ct 2002); Butcher Trusts, 20 Fid. Rep. 2d at 99, 101-02 (Mont. Cty, O. C. 2000)(citing 20 PA. CONS. STAT. § 6112 (2000); RESTATEMENT (SECOND) OF TRUSTS § 157 (1959).


3 Id. § 7742.

4 Id. § 7743.

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Use of Trusts, continued

to distributions, is more “creditor-proof” than one with mandatory distribution provisions. Compare, for example, the following two provisions governing the distribution of income from a third-party trust:

**Discretionary:** The trustee shall have the sole and absolute discretion to distribute part, all or none of the net income to the beneficiary for the beneficiary’s welfare and general best interests. Any income not distributed shall be accumulated and added to principal.

**Mandatory:** The trustee shall distribute the net income to the beneficiary for life.

Section 7744 and 7746 of the UTA set forth certain parameters for those making claims against discretionary third-party trusts (Section 7744) and those making claims against mandatory third-party trusts (Section 7746). Turning first to Section 7744, with respect to discretionary third-party trusts, generally speaking, *whether or not* a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution to a beneficiary that is subject to the trustee’s discretion, even if the trustee’s discretion is subject to standard of distribution (such as health, maintenance, support or education) unless the creditor can show that the trustee has abused its discretion or failed to comply with the distribution standard set forth in the trust. Section 7744 makes clear that this is the case even if a beneficiary is a trustee or co-trustee of the trust.

By comparison, Section 7746, which addresses mandatory third-party trusts, provides that *whether or not* the interest of a beneficiary in a trust is subject to a spendthrift provision, a creditor or assignee of a beneficiary may reach a mandatory distribution of income or principal, including a distribution upon termination of the trust, if the trustee has not made the distribution to the beneficiary within a reasonable time after the mandated distribution date. Section 7746 defines a mandatory distribution as “*a distribution of income or principal that the trustee is required by the trust instrument to make to a beneficiary, including a distribution upon the termination of the trust. The term excludes a distribution that is subject to the exercise of the trustee’s discretion regardless of whether the trust instrument includes a support or other standard to guide the trustee in making distribution decisions or provides that the trustee ‘may’ or ‘shall’ make discretionary distributions, including distributions pursuant to a support or other standard.*”

Pursuant to Section 7746, if, for example, a trust instrument creating a third-party trust provides that the trust terminates when the settlor’s child reaches age thirty-five, the child’s creditors may reach the principal if the trustee does not distribute it within a reasonable time after that date. Note that this does not apply to distributions pursuant to a standard; the creditor in those situations is relegated to proceeding under Section 7744 and even then, only certain creditors may proceed under that Section if, as will nearly always be the case, the trust includes a valid spendthrift provision.

**Withdrawal Powers.** Many practitioners routinely include provisions in their third-party trust documents that permit beneficiaries to withdraw set portions of their trusts over time. For example, a trust might provide that a beneficiary may withdraw one-third of trust principal at age twenty-five, one-half the balance at age thirty and the entire balance of the trust at age thirty-five. The rights of creditors over property in a third-party trust that may be withdrawn by a beneficiary without restriction are governed by Section 7748 of the UTA. Section 7748 provides that trust property subject to a power of withdrawal – during the period the power may be exercised and after its lapse, release or waiver – may be reached by a creditor of the beneficiary whether or not the interest of the beneficiary is subject to a spendthrift provision. Accordingly, the inclusion of such withdrawal powers eliminates any creditor protection that the trust would otherwise have, even if the beneficiary does not choose to exercise the withdrawal power, and even if the power to make the withdrawal lapses after a period. Note that Section 7703 specifically defines a power of withdrawal, and the definition excludes so-called “5 and 5” powers, so including such powers does not give rise to creditor rights when they are waived or lapsed.

**Self-Settled Trusts**

When a client has concerns about protecting his or her own assets, the client may inquire about self-settled trusts – although typically a client might refer such trusts as “asset protection” trusts or as “off-shore” trusts. For the purposes of this discussion, we will assume that the client’s focus is on potential future claimants, and that currently the client has no knowledge of any

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5 Id. § 7746.

6 Id. § 7703.
Use of Trusts, continued

present claims (or grounds for claims) against him or her. Transfers of assets that would otherwise be subject to the claims of creditors after the grounds for the claim exist are potentially fraudulent transfers, and are beyond the scope of this article. We will also assume that the client is interested in exploring domestic (United States-based) asset protection trusts, rather than off-shore trust options.

Even assuming that no fraudulent transfer rules are implicated, as matter of public policy, state law traditionally provided that the assets of a self-settled trust were available to the settler’s creditors to the maximum extent that the assets could be available to the settlor. In Pennsylvania, Section 7745 of the UTA makes clear that a revocable trust is subject to the claims of a settlor’s creditors during the settlor’s lifetime (just as they would be if the settlor owned the assets in his or her own name). In addition, if a settlor retains an interest in an irrevocable trust, those trust assets will also be subject to the claims of creditors, except to the extent that the settlor of an irrevocable trust is specifically limited with respect to the amount that the trustee may distribute to him or her (for example, if a settlor created a trust that provided for discretionary distributions to the settlor of up to one-half the principal, then that one-half the principal would be subject to the claims of the settlor’s creditors).

In 1997, Alaska passed the first statute that purported to insulate the assets of a self-settled trust from creditors even when the settlor remained a potential beneficiary of trust assets. Several other states followed suit, including Delaware, Nevada and several others. Naturally, the statutes in these various jurisdictions differ, and whether or not any particular jurisdiction is better or worse for your client’s situation would need to be carefully evaluated, as would the need for local counsel. Generally speaking, these statutes are designed to allow a settlor to transfer assets to a trust of which he or she is a beneficiary without exposing the assets to the claims of creditors. Because of the proximity of Pennsylvania to Delaware, we will briefly discuss some of the more salient aspects of the Delaware statute (the “Delaware Act”).

The Delaware Act provides that to qualify as a Delaware Asset Protection Trust, the trust must specifically reference the Delaware Act. In addition, a settlor must appoint a “Qualified Trustee,” which is a person (other than the transferor) who is a resident of Delaware, or an institution that is authorized to act as a Delaware trustee that is subject to supervision by specified government agencies. There are also various requirements for the custody and administration of the assets in Delaware. The trust must be irrevocable, however the statute includes a long list of powers that may be retained by the settlor that will not disqualify the trust from being considered irrevocable, including, for example, the power to veto distributions from the trust, a limited testamentary power of appointment in the settlor, and the right to remove and replace a trustee or other adviser (this may include a “trust protector” or other individual who may have certain broad powers granted by the trust instrument).

Perhaps most importantly, a self-settled trust will qualify under the Delaware Act if the settlor retains the right to receive trust distributions of income or principal, provided, in the case of distributions of principal, principal is received as a result of the trustee’s exercise of discretion, pursuant to a standard that does not give the settlor “a substantially unfettered right” to principal, or at the direction of an “adviser.” To qualify, a self-settled trust must also include a spendthrift clause that prohibits voluntary or involuntary transfers of the settlor’s interest in the trust.

Notwithstanding the broad protection from creditors anticipated by the Delaware Act, the Act includes some limited statutory exceptions for creditors who fall into certain categories. One exception is for a creditor of the settlor who can prove by clear and convincing evidence that the transfer to the self-settled trust was “made with actual intent to defraud such creditor.” In addition, a creditor who is entitled to support or alimony from the settlor, and tort victims who are injured (or who suffer property damage) on or before the date that a settlor/tortfeasor created a self-settled trust may reach the assets of the trust; these claimants need not prove actual intent to defraud to recover trust assets. A successful creditor may be entitled not only to assets of the self-settled trust (in an amount necessary to satisfy the claim), but also to attorneys’ fees, in the discretion of the court.

7 Codified as title 12 of the Delaware Code, sections 3570-3576.
9 Id.§ 3570(7),(8).
10 Id.§ 3570(11)b.
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The Private Foundation Lifespan: Perpetual or Limited?

By RICHARD L. FOX
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Private foundations offer an opportunity for the original founders to leave behind a charitable entity to carry on their philanthropy for generations to come. Indeed, private foundations have traditionally been designed to exist in perpetuity. However, they remain untested by the courts. Many commentators believe that only trust assets actually administered in the jurisdiction governing a particular asset protection trust and subject to the courts of that same jurisdiction will be protected by a state’s asset protection trust statute. In time, litigation is likely to better define the scope of the protection afforded by the Delaware Act and similar statutes in other jurisdictions.

Use of Trusts, continued

Domestic asset protection trusts (as distinguished from offshore trusts, in jurisdictions such as the Cook Islands or Isle of Man, for example) may be a useful planning strategy for some clients. However, they remain untested by the courts. Many commentators believe that only trust assets actually administered in the jurisdiction governing a particular asset protection trust and subject to the courts of that same jurisdiction will be protected by a state’s asset protection trust statute. In time, litigation is likely to better define the scope of the protection afforded by the Delaware Act and similar statutes in other jurisdictions.

A Note about Federal “Super Creditors”

Trusts have an important place in an estate planner’s tool kit for many reasons, but more and more clients are highly interested in the creditor protection that trusts can provide. Third-party trusts remain a very good tool for insulating the assets of beneficiaries from creditors’ claims, particularly in Pennsylvania. Certain federal creditors, however, may be able to reach trust assets that other creditors cannot. Specifically, the IRS and SEC, which have federal collection statutes, are not limited to traditional state law collection procedures or the Federal Rules of Civil Procedure. This is an area of the law that is evolving, but generally trusts with provisions that grant trustees complete discretion in making distributions, and those that have many beneficiaries seem likely to fare better than trusts that mandate distributions and that have a single beneficiary. Although a detailed treatment of this topic is beyond the scope of this article, estate planners who advise clients on the creditor protection aspects of trusts would do well to remind clients that even the best-drafted trusts may not necessarily be protected from the claims of certain federal creditors.

It is estimated that only approximately 12% of today’s private foundations plan to limit their lifespan or are currently in the process of spending down their entire asset base during a predetermined period of time. Renza and Wolcheck, “Perpetuity or Limited Lifespan, How Do Family Foundations Decide?,” Foundation Center in Cooperation with the Council on Foundations (April 2009).

1 Foundations such as Rockefeller and the Carnegie Corporation helped bring about the large scale organized philanthropy that exists in this country today, including spurring on the creation of thousands of private foundations by individual donors used to further their philanthropy.

2 Although founders usually make the decision regarding the lifespan of their foundation, in the absence of a clear mandate by the founder requiring perpetuity, successor trustees may be in a position to make the determination to opt out of the perpetual foundation model and adopt sunset provisions.


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Private Foundation Lifespan, continued

date for addressing solutions to specific foundation programs and causes. The debate over whether foundations should last in perpetuity or spend down their assets over a specified time period has taken on increased visibility of late. The fact that the largest private foundation in the country, the Bill and Melinda Gates Foundation, has announced its intention to spend all of its resources and terminate 50 years following the last to die of its current trustees, has certainly sparked an interest in this issue. So too has the recent announcement of other philanthropists of their intention to limit the lifespan of their foundations, as well as many such philanthropists urging other foundations to consider following suit and spend down their funds within a specified period of time. The recent highly publicized “Giving Pledge,” involving the commitment of many of the wealthiest American families and individuals to give at least half of their wealth to charitable causes during their lifetimes, has also brought into focus the concept of attacking today’s problems with today’s money.


These include such individuals as Warren Buffett, Jennifer and Peter Buffett (the son and daughter-in-law of Warren Buffett), Charles Feeny, Paul Brainerd, and Tim Gill.

See, e.g., Frazier “Every Dollar Spent,” The Chronicle of Philanthropy (May 21, 2009). This article focuses on the decision of John Hunting, the founder of the Beldon Fund, to limit the life of his foundation to 10 years. The article notes that “Beldon officials are working to get the word out” and have “written a guide for other grant makers about how to run a foundation that deliberately operates for a short time.” Mr. Hunting is quoted as stating that “I personally think any foundation should consider spending out. I believe in solving today’s problems with today’s money.” The Beldon Fund made its last grants in June 2008 and closed its doors at the end of May 2009.

See Brill, “Stepping Up To The Lifetime Giving Challenge,” Forbes (August 2, 2010). A listing of those taking the pledge, which includes Bill Gates and Warren Buffett, The private foundation lifespan issue has also taken on increased significance because many foundations created in the later part of the 20th century are now facing issues in connection with the transition in foundation leadership, which may lead to the consideration of limited lifespan options. The determination of a private foundation’s lifespan is no easy task, as there are a multitude of factors that should be considered in this context and there is no one lifespan approach applicable to all foundations. Although considerable time and effort usually go into the process of establishing a foundation, much less thought, if any, is given to the lifespan of the foundation, much less thought, if any, is given to the lifespan of the foundation.

5 Ostrower, “Limited Life Foundations, Motivations, Experience and Strategies,” The Urban Institute (February 2009) (”Most foundations are established in perpetuity, but the limited life option is starting to attract more attention, including media coverage of high profile examples.”) For example, the issue of foundations adopting a limited lifespan as opposed to the historical perpetual model has been discussed in a number of recent articles in both the New York Times and the Wall Street Journal. See, e.g., Beatty “Families Wrestle With Closing Foundations,” Wall Street Journal (April 17, 2007); Banjo, “Philanthropists Set Spending Deadlines,” Wall Street Journal (May 21, 2009) (“A growing number of philanthropists are adopting spending deadlines and sunset provisions”); Jacobs, supra, note 4; Mincer, “Foundations Rethink Going Long,” Wall Street Journal (December 17, 2010). There have also been various opinion pieces advocating the limited life model. See, e.g., “Every Dollar Spent,” The Chronicle of Philanthropy (May 21, 2009); Feeeney, “Setting an End Date Focuses Foundation Giving,” The Chronicle of Philanthropy (June 2, 2011).
Private Foundation Lifespan, continued

foundation. It is clearly beneficial, however, for founders of private foundations to consider the issue of perpetuity versus limited life and the earlier this issue is considered, the better, including when the foundation is first created. This article discusses various issues to consider in addressing whether private foundations should be designed to exist in perpetuity or to spend down their entire endowment over a limited lifespan. It is not intended to advocate a particular position but to shed light on the topic so that donors are in a better position to confront this issue based upon their own beliefs and circumstances, including the particular mission, goals and strategies of their foundations.

FACTORS FAVORING LIMITING THE LIFESPAN OF A PRIVATE FOUNDATION

Concern About Mission Drift After Donor’s Death

The most common argument for adopting the limited life model is that it ensures adherence to the mission of the foundation as envisioned by the founder, so that its funds will be used in a manner that honors the intent of the founder and preserves the founder’s level of charitable engagement. Perpetual foundations, it is argued, have a tendency to drift away from, or even reverse, that mission following the death of the founder thereby thwarting donor intent. And, although founders may seek to rule from the grave by adopting charter provisions mandating how foundation funds are to be spent, the best way for founders to ensure adherence to their charitable intentions is for them to become actively involved in expending such funds during their lifetime and to direct the disposition of the remaining funds upon their deaths. For fear of mission drift, for example, the John M. Olin Foundation, originating in 1953 from the financial success of the chemical and munitions tycoon, was one of the first private foundations to adopt a limited life model, having previously closed its doors in 2005. During its life, the foundation focused solely on economic issues, seeking to bolster the free market system, mostly through funding conservative think tanks and programs at major universities throughout the country. Mr. Olin didn’t want his foundation to outlive the trustees who actually knew him and what he wanted to accomplish. He also was concerned that if his foundation were to continue forever, it might stray from its conservative principles. The more removed a foundation’s leadership becomes from its founder, the less guarantee there is that the foundation will be used to further the founder’s wishes. Some founders also take the position that it is not fair to rule from the grave and burden their children with their charitable interests. An alternative in these cases is to put the children in a stewardship role following the donor’s death for the purpose of distributing the remaining funds as the founder intended and then closing the foundation. Certain founders have no desire to rule from the grave and, therefore, although opting for the perpetual model, they do not impose their charitable interests on future generations, but allow such future generations to make their own philanthropic decisions.

Do as Much as Possible as Soon as Possible

A leading factor in adopting the limited life foundation model is to ensure that urgent needs are addressed

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Private Foundation Lifespan, continued

as soon as possible.17 Without the burden of lasting in perpetuity and the related concern about preserving an endowment, foundations have greater freedom in their grantmaking decisions. By distributing the entirety of a foundation’s funds within a limited time period, founders can have a bigger immediate impact than traditional perpetual foundations that only make the minimum 5% annual distribution required by law.18 The move by the Gates Foundation to eventually shut its doors reflected a decision by its three trustees, Bill Gates, Melinda Gates, and Warren Buffett, to do “as much as possible, as soon as possible, to further its work.”19 In making its decision to sunset, the Bill and Melinda Gates Foundation emphasized its commitment to immediate and grand-sweeping action in social reform, stating that the “decision to focus all of our resources in this century underscores our optimism for making huge progress and for making sure that we do as much as possible, as soon as possible, on the comparatively narrow set of issues we’ve chosen to focus on.”20 The Beldon Fund, which, during its life focused on environmental policy, also saw fit to put in place a ten-year spend-down plan, ultimately closing its doors in 2009. With the adoption of the limited life plan, founder John Hunting attained a clear legacy in the work to which he dedicated his life earnings. The foundation was funded in 1998 with $100 million by Mr. Hunting, who decided that the entire amount should be distributed “within 10 years to build a national consensus to achieve and sustain a healthy planet.” Hunting’s decision to limit the life of his foundation reflected his belief “in the urgency of this mission and a strong sense that making large investments over a shorter period of time would be more effective than making smaller grants over many years.”21 Mr. Hunting has stated that he believes “in solving today’s problems with today’s money” and that he thinks that, “any foundation should consider spending out.”22 The New York-based Atlantic Philanthropies has announced its intention to spend its entire endowment by 2020. In reaching its decision to adopt the limited life model, that foundation has stated that “We were encouraged by the success and impact of other foundations that adopted a limited time frame in which to accomplish their missions. Their examples convinced us that a short period of concentrated investment in the issues we feel most passionately about is likely to bring about greater improvements in the lives of disadvantaged and vulnerable people.”

Greater Impact, Involvement and Satisfaction by Founder Giving While Living

A leading factor supporting limiting the life of a foundation is the desire of the founder to have a greater impact during his or her lifetime and to be directly involved in how the foundation’s assets are spent.23 The founders in this context want personal engagement with giving during their lifetime, desire to personally direct their giving, enjoy the pleasure that results from their philanthropy, and seek to use their own skills and experience to address their charitable causes. Such individuals often speak of the “fun, the “joy,” and the “fulfillment” derived from accomplishing their philanthropy during their lifetime.24 Atlantic Philanthropies founder Charles Feeney, co-founder of the Duty Free Shoppers Groups, has been one of the most prominent advocates of the “Giving While Living” policy since the 1980’s, stressing that donors should spend their philanthropic resources while they are alive. By 2002, his international foundation had made grants totaling $2.5 billion. In that same year, in keeping with Mr. Feeney’s Giving While Living philosophy, the Atlantic Philanthropies announced that it would spend down its remaining assets and close its doors by 2020. A recent report, “Turning Passion Into Action: Giving While Living,” published by the Atlantic Philanthropies in June 2010, states that “Giving While Living is becoming an increasingly popular option for high-net-worth individuals” and profiles philanthropists who have taken a variety of approaches in adopting

17 See Banjo, supra, note 5; Feeney, supra, note 5 (in an opinion piece, the author states that the decision to close the family foundation down was made “when it became clear that we would be more effective making larger grants now than if we spent less over a long time.”).
18 IRC § 4942.
19 See Beatty, supra, note 6.
20 Bill and Melinda Gates Foundation website, posted on November 29, 2005.
21 Part of a message from Beldon Fund founder, John Hunting, which can be found at: www.beldon.org.
22 See Frazier, supra, note 8.
23 See Renza and Wolcheck, supra note 1.
24 See Ostrower, supra, note 5 (in one case cited in this report, a child speaking of her father’s reason for setting up a foundation with a sunset provision, said that her father “wanted to pleasure of giving it away while alive”).

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Private Foundation Lifespan, continued

this philosophy. The report notes that Atlantic Philanthropies, the Gates Foundation and George Soros’ Open Society Institute did not exist 25 years ago. “In another 25 years,” the report further states, “there will be other resources available, so why not do what we can in our lifetime to make an impact on social problems?”

Greater Efficiencies and Focus

A factor often cited in support of a spend-down model is a belief that foundations are more efficient when working within a limited lifespan. By spending funds in a shorter period of time, foundations may become increasingly strategic in the focus of their philanthropy, become more effective in achieving a particularly philanthropic outcome, and realize a greater impact. In the case of the French American Charitable Trust, for example, which will close later this year, the president of the organization has stated: “We came to this decision gradually, when it became clear that we would be more effective making larger grants now than if we spent less over a long time… When we began to think about how to operate in a world in which we’re not trying to ensure the foundation’s perpetuity, we had to think more strategically about our priorities and results, and we also became more creative.” Not being subject to the perpetual model allows smaller foundation to make larger grants that can put it at a level of leadership that would require a much higher asset base if it didn’t plan to spend down its funds.

Loss of Control of Foundation to Others

A concern of the founder of a family foundation that it might ultimately be run by non-family members is another reason supporting the limited life foundation model. For example, the Ford Foundation currently has no Ford family members on its board. The Fords lost control of the foundation in the 1950s, and the last family member, Henry Ford II, resigned from the board 30 years ago. Certainly, provisions may be incorporated into charters to attempt to ensure family control in perpetuity, although the eventual loss of family control potentially remains a possibility due to change of circumstances or unanticipated events taking place.

Aversion to Institutionalized Philanthropy

Many founders of foundations choose the limited life model out of an aversion to institutional philanthropy, which they see as bureaucratic and wasteful. The fear here is that the foundation’s primary purpose ultimately is to maintain itself and that over time, the foundation turns into a self-perpetuating bureaucracy, becomes stagnant, and spends significant sums on overhead and administrative expenses. Some donors choose to sunset their foundations to avoid the difficult governance issues that necessarily are involved when transitioning control of a foundation to future generations.

Uncertainty About Family’s Future Commitment to the Foundation

Uncertainty about a family’s future commitment to a foundation, its mission and the ability of family members to work together also support the adoption of the limited life model. Descendants of founders may also not share the founder’s passion for the organization’s mission or may not want to commit time or have the interest or ability to manage the foundation. As the number of family members grow, scatter geographically and have differing charitable interests, there may be difficulty in building a consensus regarding the foundation’s direction and grantmaking. Family members may not get along and may be unwilling to work together, even to attain what would otherwise be worthwhile charitable goals. Many founders also do not want to burden future generations with maintaining the foundation and the responsibility for continuing to run the foundation.

Belief That Future Generations Will or Should Create Their Own Foundations

Many founders of private foundations are confident that their future generations will create their own wealth and use their own funds to address the problems of

25 Among those profiled include Tim Gill, the software entrepreneur who invented the page layout Quark. His Gill Foundation, which was founded in 1993 and in 2008 gave grants totaling just over $10 million, is to spend itself out of existence within 20 years of Mr. Gill’s death.

26 See Renza and Wolcheck, supra note 1; Ostrower, supra, note 5.

27 See Feeney, supra, note 5. Interestingly, the president also acknowledged that adopting a limited life foundation “was not something we even anticipated 20 years ago when our parents created the fund for their five grown children.”

28 See Ostrower, supra, note 5.

29 One possible solution to this is to split the foundation up among branches of a family by creating separate successor foundations or donor-advised funds.
Private Foundation Lifespan, continued

the future. Those choosing the spend-down model also often adopt the attitude that the next generation should create their own philanthropic capital for their own priorities and mission. Indeed, new foundations seem to emerge virtually every day.

FACTORS FAVORING THE PERPETUAL LIFE PRIVATE FOUNDATION

Addressing Long-Term Philanthropic Concerns

Perhaps the leading factor for adopting the perpetual foundation model is that it provides the foundation with the ability to meet the long-term philanthropic objectives of the foundation through its grant-making. This includes the ability to create a sustained, long-term impact on the community, fund particular causes of the foundation that will continue to need investment over time, address changing or future needs, and to deal with complicated global or domestic issues that may take decades in order for the foundation to make a lasting impact. The perpetual model also allows for the sustained funding for the region the foundation serves, including allowing the foundation to provide vital support if the community served by the foundation should become economically distressed. Similarly, by having funds available in perpetuity, the founder knows that there will be resources available in the future to meet other areas of need in which the government or other charitable organizations may not be able to address.

Continued Funding of Grantees

Another important advantage of the perpetual model is that the grantees of the foundation will continue to receive much-needed funding that they have traditionally relied upon to sustain their programs. Often, grantees will have difficulties bridging the gap in funding, and potentially face closure, if the foundation has historically provided it funding ceases operations. Thus, the perpetual model offers the foundation’s grantees, or in some cases, an entire charitable field of endeavor, the opportunity to continue to receive support necessary for them to continue to work. This is particularly the case if the foundation is located in a region lacking other foundations who would not take up the slack if the foundation were to terminate. Although a terminating foundation could create endowments at its historical grantee organizations, there is often a concern that smaller grantee organizations are not in a position to manage a large endowment and, for that reason, there may be a bias to give endowment funds to larger and more established charitable organizations that have experience operating an endowment fund.

Desire of Founder to Leave a Lasting Legacy

The perpetual foundation model keeps the names of the foundation’s founders alive and continues to recognize their charitable legacy and objectives for years to come. A family foundation also represents the founder’s charitable objectives and the perpetual foundation model allows for the continued implementation of these objectives.

Desire for Family Engagement in Philanthropy Across Generations

An important consideration in determining whether to adopt the limited life or perpetual model is that the perpetual foundation model offers the opportunity to preserve a family’s philanthropic legacy for future generations. Indeed, the perpetual model offers family-related advantages, such as engagement in philanthropy across generations, training in philanthropy, shared responsibility and family unity. Private foundations have also traditionally been thought of as vehicles to bind future generations of a family through involvement in the foundation’s direction and activities, a factor weighing in favor of the perpetual model.

Avoidance of Proliferation of Solicitation of Funds

A decision to spend down private foundation funds often results in a proliferation of solicitation of funds once the plans are announced.

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30 Mincer, supra, note 5,described husband and wife founders who decided to have their foundation last until their deaths, at which time any remainder assets would be donated to another foundation. The father told his children, “We have our foundation, and it gives up a great deal of satisfaction, and you may choose to do that.” All of the children subsequently set up their own foundations, each with their own causes.

31 See Banjo, supra, note 5 (quoting the president and chief executive officer of Rockefeller Philanthropy Advisors as stating that those who choose to spend down are saying, “Let the next generation create new philanthropic capital for their own priorities and mission.”

32 See Renza and Wolcheck, supra, note 1.

33 See Renza and Wolcheck, supra note 1.

34 See Ostrower, supra, note 5.

35 See Renza and Wolcheck, supra, note 1.

continued on Page 13
Private Foundation Lifespan, continued

which is obviously avoided in the case of perpetual foundations. Foundations that do opt for the limited lifespan model may be best served, therefore, by remaining silent about their plans to spend down their remaining funds.

Conclusion

The issue of whether a private foundation should adopt a perpetual or limited lifespan model has clearly taken on increased visibility of late. Although the perpetual model still remains the norm, philanthropists are increasingly adopting the spend-down or limited lifespan model for their private foundations. The determination of a private foundation’s lifespan is no easy task, as there are a multitude of factors that should be considered in this context and there is no one lifespan approach applicable to all foundations. Founders of private foundations, however, should clearly consider this issue based upon their own beliefs and circumstances, including the particular mission, goals and strategies of their foundations.

36 See Ostrower, supra, note 5.

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CASE SUMMARIES FROM THE ORPHANS’ COURT
LITIGATION COMMITTEE

and
Lanzetta Estate, 1 Fid. Rep. 3d 352 (O.C. Mont. 2011)

By TIMOTHY J. HOLMAN, ESQUIRE AND BRADLEY D. TEREBELO, ESQUIRE
HECKSCHER, TEILLON, TERRILL & SAGER, P.C.1

In the October 2010 Quarterly Newsletter, we analyzed In re: Novosielski, 992 A.2d 89 (Pa. 2010), in which the Pennsylvania Supreme Court “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.”2 Two cases published after Novosielski – Estate of Cella, 12 A.3d 374 (Pa. Super. 2010) and Lanzetta Estate, 1 Fid. Rep. 3d 352 (O.C. Mont. 2011) – reinforce the difficulty in rebutting the statutory presumption in the MPAA that the funds in the joint accounts, even “convenience accounts,” pass to the surviving joint owner(s) and not pursuant to the decedent’s will.

By way of background, 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 Estate of Cella, 12 A.3d 374 (Pa. Super. 2010), the decedent opened three bank accounts, naming his sister the joint owner. Subsequent to the creation of the joint accounts, the decedent executed his will, which gave his estate in equal shares to his grandchildren. Decedent’s sister, the executor, petitioned the Allegheny County Orphans’ Court to set aside the joint designation on the accounts and order that the accounts be distributed in accordance with decedent’s will. It was stipulated that decedent solely funded the accounts, that the accounts were opened as joint accounts with decedent’s sister and that decedent did not intend an inter vivos gift of the money in the accounts to the sister.

The Orphans’ Court (which issued its decree prior to the Supreme Court’s decision in Novosielski) found that decedent treated the money in the accounts as his own during his lifetime, the sister was “simply the person who signed the checks from the accounts, the sister exercised no dominion or control over the funds prior to decedent’s death and that the accounts were created as convenience accounts. Accordingly, the Orphans’ Court held that clear and convincing evidence had been presented to rebut the statutory presumption in the MPAA that the funds in the joint accounts should pass to the sister and instead ordered that the funds should be distributed pursuant to decedent’s will to the three grandchildren.

The Superior Court reversed the Orphans’ Court’s decree. Relying heavily on the Supreme Court’s decision Novosielski, the Superior Court noted that the burden is on the party wishing to rebut the presumption of survivorship to produce evidence “‘so clear, direct, weighty, and convincing that the fact finder could without hesitation, come to a clear conviction that Decedent, in fact, had not intended’ a right of survivorship regardless of how the accounts were created.” Cella, 12 A.3d at 380 (quoting Novosielski, continued on Page 16
Case Summaries, continued

992 A.2d at 106). Furthermore, the proponent of the survivorship presumption “is not required to come forward with additional evidence of the decedent’s intent at the time the account was created.” Cella, 12 A.3d at 380 (citing Novosielski, 992 A.2d at 106). Importantly, the Superior Court reiterated that the creation of a will “does not defeat the survivorship presumption that the joint accounts should pass pursuant to the will.” Id. According to the Superior Court, the executor did not provide “clear and convincing” evidence to rebut the statutory presumption that the joint accounts should pass to the sister, and it remanded the case to the Orphans’ Court.

In Lanzetta Estate, 1 Fid. Rep. 3d 352 (O.C. Mont. 2011), the decedent funded an account in the amount of approximately $30,000, naming his daughter the joint owner. The assets were funded solely by decedent, and, with the exception of one check daughter wrote to fix a window that her son broke, she never recalled using any of the money in the account for her own purposes during decedent’s lifetime.

The son objected to the assets in the account passing solely to the daughter, claiming that the account was a convenience account and that the funds should pass pursuant to decedent’s will (executed prior to the creation of the joint account), which would give the funds equally to son and daughter. The son presented a letter from decedent’s attorney in 2005 (after the creation of the joint bank account), in which he indicated that all of decedent’s assets, including “cash in a bank account” in the amount of approximately $30,000 would pass equally to his children, as per his 1995 will[,]” which was insufficient. The Court therefore held that the brother did not provide clear and convincing evidence to rebut the presumption that the joint account should pass to the daughter.

Both Cella and Lanzetta reinforce the difficult standard of 20 Pa. C.S. §6304, as analyzed and applied by the Supreme Court in Novosielski, to rebut the presumption that a joint account should pass to the surviving joint owner at death. As more and more clients see joint ownership as a “convenient” means of avoiding reliance on a general powers of attorney to conduct financial affairs (which can be a difficult process with some financial institutions) or even avoiding probate, practitioners must be extremely diligent when advising clients on the ramifications of how (and to whom) these assets will pass at death.
PRACTICE POINTS

Some Special Circumstances Regarding the Filing of the Pennsylvania Inheritance Tax Return

By BERNICE J. KOPLIN, ESQUIRE

While the majority of Pennsylvania Inheritance Tax Returns are routinely filed with the Register of Wills as Agent for the Commonwealth, the reader should be mindful of the following less routine circumstances:

1. If the estate contains a closely held company or documents which may be sensitive, those papers can be filed directly with the Pennsylvania Department of Revenue and not included with the returns filed with the local Inheritance Tax department at the Register of Wills.

2. If an estate was not probated because all of the assets were held in trust, the Trustee or Counsel must appear in person at the Register of Wills with the Inheritance Tax Return for filing. A file number will then be issued and the Return accepted for filing. There is usually a fee of about $50.00 for this filing. Please note that an Inventory is not necessary if all of the assets were held in trust.

Since the trust document should specify the successor trustee to serve after the death of the Settlor, or there may already be a named Co-Trustee who has been serving with the Settlor, the trust document and a death certificate should be sufficient to remove the deceased Co-Trustee from the registration of any assets.

3. A situation which could cause difficulty in the payment of the discount Pennsylvania Inheritance Tax payment is when only a photocopy of the Will can be located. If the intestate provisions are the same as that of the Will the estate could be raised and administered by Administrators (however a bond may be required, which would more likely than not be waived in the Will). However, if the terms of the Will are not the same as the intestate provisions, and all interested parties are in agreement, the named Executor(s) must petition the Register of Wills to accept the photocopy for probate. This involves the consent of the interested parties and someone who is familiar with the decedent’s signature to swear that the signature is legitimate, and also the knowledge that the Will was probably not revoked. As this may add significant time to the probate of the Will and thus prevent the Executors from accessing the decedent’s funds, the interested parties must make the “discount” payment on behalf of the estate or the opportunity will be lost. The payment is still made at the Register of Wills Inheritance Tax Department, but a request for a temporary file number must accompany the payment. A fee of approximately $50.00 must accompany this request. Once the petition to probate the photocopy has been granted, the Register of Wills will issue Short Certificates with a permanent file number which becomes the one of record and the temporary file number is no longer used.

4. Where a non-resident estate contains Pennsylvania real estate, the Pennsylvania Inheritance Tax Division in Harrisburg should be contacted with the request to have a file number assigned to the non-resident estate for filing the Inheritance Tax Return.
What may a lawyer do when it appears the client-executor does not intend to timely or properly distribute estate assets?

As noted in the comment to Rule 1.6, which governs the confidentiality of information, “A fundamental principle in the client-lawyer relationship is that in the absence of the client’s informed consent, the lawyer must not reveal information relating to the representation.” Because the executor is the client of the lawyer, and the beneficiaries are not the clients, the lawyer is clearly limited in what he or she may say to the beneficiaries and others about the executor’s behavior.

Fortunately, a lawyer caught with a misbehaving executor is not necessarily reduced to becoming a merely passive observer of the client’s behavior. In fact, Rule 1.6, itself, provides numerous clues to the path that the lawyer may follow.

Rule 1.6(b) points to Rule 3.3 which obligates a lawyer to correct misrepresentations or to report improper actions when a tribunal, which, of course, includes the Orphans’ Court and the Register of Wills, is involved. For instance, if a petition for letters, an inventory or account misrepresent the facts, the lawyer normally would have an obligation to correct those documents, if the client does not do so, when the lawyer prepared or filed the documents or if the lawyer has been asked to take action or has taken action based in information in those documents.

Rule 1.6(c) also permits the lawyer to reveal such information to the extent the lawyer “reasonably believes necessary” to (i) stop a criminal act likely to result in substantial injury to the financial interest or property of the beneficiary, and (ii) prevent, mitigate or rectify the consequences of a client’s criminal or fraudulent act, in the commission of which the lawyer’s services are being or had been used. Unlike Rule 3.3, however, the reporting pursuant to Rule 1.6 (c) is merely permissive.

Finally, Rule 1.16(a)(1) mandates the lawyer’s withdrawal from the matter if the lawyer’s services will be used by the client to materially further a course of criminal or fraudulent conduct.

It also should be remembered that as a matter of substantive law, Pennsylvania lawyers have been held to owe certain duties to the beneficiaries even though they are not clients. In a well known Orphans’ Court case, Pew Trust, 16 Fiduc. Rep. 2d 73 (Montg. 1995), the court held that while a lawyer does not represent the beneficiaries of the estate, the lawyer has “derivative duties” to the beneficiaries similar to those duties owed to them by the fiduciary.

Of course, in addition to remonstrating with the client, the lawyer should emphasize the probability that the lawyer will be obligated to disclose the problem to the beneficiaries and, conceivably, to the court, depending on the posture of the estate. Often, the lawyer’s alerting the executor of the lawyer’s obligation to disclose the problem is sufficient to convince the executor to mend his or her ways.

So what should the lawyer do when the executor fails to timely or properly complete the distribution and, possibly, stops communicating with the lawyer? A four-step approach might be effective: First, the lawyer should send a detailed and, if necessary, repeated written instructions to the executor setting forth the executor’s obligations to proceed with the distribution. Second, assuming the executor is not responsive or fails to proceed, the lawyer should warn the executor that the lawyer will be obligated to notify the beneficiaries of the failure to make the distribution and that the lawyer will be obligated to withdraw as counsel. Third, having reminded the client of his or her duties and warned the client of the consequences, the lawyer should notify the beneficiaries of what is due them and that the lawyer is in the process of withdrawing as counsel for the fiduciary. Going further, the lawyer can advise the beneficiaries continued on Page 19
Ethics Column, continued

that he or she is no longer in a position to answer questions about the estate’s status and advise them that they should seek counsel if they have any questions about the administration. Incidentally, this kind of withdrawal, sometimes called a “noisy” withdrawal, is usually sufficient to alert the affected parties, here the beneficiaries, that there is an issue and that they should take appropriate action. Finally, the lawyer should be certain to properly effect his or her withdrawal from the representation which should include sending an appropriate withdrawal notice to the Office of the Register of Wills where the will was probated.

For additional reading on the subject of misbehaving executors see Formal Opinions 2011-14 and 2008-9 issued by the Philadelphia Bar Association’s Professional Guidance Committee and Formal Opinion 2009-21, issued by the Pennsylvania Bar Association’s Legal Ethics and Professional Responsibility Committee.

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TRANSFER TAX UPDATE

By MARGERY J. SCHNEIDER, ESQ., LLM (TAX)

1. FEDERAL ESTATE TAX ESTATE INCLUSION

Estate of Jorgensen v. Comm’r, 2011 WL 1666930 (9th Cir. May 4, 2011)

In an unpublished memorandum decision, the Ninth Circuit affirmed the Tax Court’s 2009 decision, Estate of Jorgensen v. Comm’r, TC Memo. 2009-66 (March 26, 2009) and held against the estate on all issues.

In the appeal, the estate presented new arguments that decedent Emma Jorgensen, who with her deceased husband had transferred interests in marketable securities to one family limited partnership and had established a second family limited partnerships after his death, had received only de minimis benefits from the transferred property and that only the actual amount accessed by the decedent should come under § 2036(a).

The court found that the tax court did not err in determining that the decedent had impliedly retained the economic benefits of the transferred property. The post transfer amounts that the decedent received from the FLPs were not de minimis: the decedent wrote $90,000 in checks to make personal gifts to family members and partnership funds were used to pay more than $200,000 of her estate taxes. It affirmed the tax court’s finding of an implied agreement between the decedent and the partnerships that allowed her to write checks on the partnership account and use any amount of the transferred assets that she desired, even though she was only a limited partner.

The court also found that the tax court did not err in its conclusion that the transfer was not a bona fide sale for full and adequate consideration. The estate did not succeed in proving that nontax business reason for the transfers met the definition of “legitimate and significant” under Estate of Bigelow v. Comm’r, 503 F.3d 955 (9th Cir. 2007). The Ninth Circuit concluded that “the overriding objective purpose [for the transfers] appeared to be a mere ‘recycling of value’ into the partnership vehicle to permit discounted gift-giving and/or reduce the ultimate estate tax owed” via discounting.

Estate of Coaxum v. Comm’r, T.C. Memo. 2011-135 (June 16, 2011)

The Tax Court found that the proceeds of six life insurance policies were includible in a decedent’s estate because the decedent retained incidents of ownership under IRC § 2042. It also found that the value of annuities owned by the decedent were includible in his estate under IRC § 2039.

Decedent, Edward Thomas Coaxum, owned seven insurance policies providing death benefits at the time of his death. One policy had no value, and the other six were initially valued on the decedent’s estate tax return at $1,286,577. As of the date of his death, the decedent had the right to select the beneficiary on all six policies. Decedent also owned annuities valued at $472,956 at his death, but they were reported on his estate tax return as having zero value. The estate tax return was filed more than 30 months after his death.

The IRS issued a notice of deficiency, stating that the insurance policies should be included in the gross estate at the slightly modified value of $1,283,184 and that the annuities should be reported at their full value. In an amended petition, Decedent claimed that the both the insurance policies and the annuities were not required to be included in his estate.

The Court held that the six life insurance policies were includible in Decedent’s gross estate because in retaining the right to change their beneficiaries Decedent retained an “incident of ownership” under IRC § 2042(2). The Court also held that the annuities were includible in the estate under IRC § 2039(a). Decedent’s Estate had argued that Decedent’s brother, who was the beneficiary of the annuities and included the annuity payments in gross income as “income in respect of a decedent,” should have the right to deduct the Federal Estate Tax paid on the annuities to offset his income tax payments. The Court rejected this argument, stating that it had no jurisdiction to rule on the Decedent’s brother’s income tax liability.

The Court assessed a 25% “failure to file” penalty under IRC § 6651(a)(1), because the Estate did not demonstrate “reasonable” cause or a lack of “willful neglect” for its late filing.

continued on Page 21
Transfer Tax Update, continued

Estate of Turner v. Comm’r, T.C. Memo. 2011-209 (August 30, 2011)

The Tax Court ruled that the assets transferred to a family limited partnership during a decedent’s lifetime must be included in a decedent’s gross estate under IRC § 2036, because the taxpayer presented no legitimate non-tax reason for the transfer. The court held that the transfer was not a bona fide sale but was performed primarily for tax reasons.

The decedent, Clyde W. Turner, Sr., died on February 4, 2004. He had formed a successful lumber company with his brothers and had invested heavily in one bank stock whose value had appreciated significantly. In 2002, he and his family formed a family limited partnership, the Turner & Company Limited Liability Partnership (“LLP”). The family limited partnership held cash, shares of stock in a bank on whose board of directors various family members had served, CDs and other marketable securities. The decedent retained $2 million of assets outside of the partnership.

In late December, 2002 and early January, 2003, the decedent and his wife gave LLP interests to their children and grandchildren. The court stated that the bona fide sale exception to IRC § 2036 was not met because the decedent could not demonstrate a legitimate and significant nontax reason for forming the partnership. It found that none of the principal reasons asserted by the decedent – (a) consolidation of assets to perpetuate asset management, (b) resolution of family disputes and (c) protection of family assets – was a legitimate reason for the formation of the LLP. (a) Consolidation of assets could not be a legitimate nontax purpose if the partnership is “just a vehicle for changing the form of the investment in the assets, a mere asset container.” Here, all of the assets were passive investments for which active management was not required. (b) The LLP was not a significant tool for resolving family disputes because there was no evidence of ill will among the decedent’s children concerning money. (c) Asset protection was also not deemed to be a legitimate purpose for the LLP, nothing in the record indicated that the assets in the LLP were being protected from a grandchild who had a drug problem. Moreover, the $2 million in assets held outside the LLP continued to be exposed to this grandchild. The court listed several additional factors that indicated that the transfers were not a bona fide sale.

The court found that the decedent retained an interest in the transferred property under IRC § 2036(a)(1) because he paid himself excessive management fees of $2,000 per month and he retained the right to amend the FLP agreement at any time without the consent of the limited partners. Furthermore, because of his stated personal attachment to the bank stock held by the FLP, there was an implied agreement that it was never to be sold. Among the additional reasons cited by the court was the fact that the decedent drew a management fee from the FLP even though he had kept enough assets outside of the FLP to meet his living needs.

The court also determined that the FLP did not meet the requirements of IRC § 2036(a) (2) because he retained the right to designate which person would enjoy or possess FLP assets. The decedent had sole and absolute discretion to make pro rata distributions of FLP income and to make distributions in kind. He also had the right to amend the FLP agreement, as stated above.

Concerning an additional and unrelated issue litigated in this case, the court held that the fact that insurance premium payments were made directly to an insurance company without the issuance of Crummey notices would not cause estate inclusion, because the trust agreement gave the beneficiaries the right to demand withdrawals after each “direct or indirect” transfer to the trust.

ESTATE TAX DEDUCTIONS


Theresa Beat was the executrix and sole beneficiary of the Estate of Darrel Dean Dyche, who died on July 14, 2001. The estate assets were valued at approximately $4 million, with about $3.6 million in farm land, farm equipment and grain. The estate had distributed almost all of its assets to Beat in 2001, 2002 and 2003, and she had signed a “Receipt
Transfer Tax Update, continued

and Refunding Agreement” in 2001 and 2002 agreeing to refund any portion of the distribution to pay any additional tax assessments. In 2002 a timely Form 706 was filed, showing no tax due because of a marital deduction. Beat pursued a separate state court action declaring that she and Dyche did have a common law marriage.

In 2005 the IRS denied the marital deduction sought on the return and assessed taxes, penalty and interest of $2.9 million. Beat took out a personal loan to pay that amount, then, as executrix, filed a lawsuit seeking a refund. The IRS challenged the executrix’s contention that the estate was entitled to a deduction for the bank loans Beat had taken out and in turn loaned to the estate. But at the time when the court had granted the partial summary judgment to the U.S. on the issue of whether the Estate could claim a marital deduction, the IRS had stated that it did not object to a deduction for the bank loan, along with deductions for other administrative expenses. The district court ruled that the earlier failure of the IRS to oppose the deductions was a “binding judicial admission… which cannot be repudiated at will.” Furthermore, the court found that the deductions were “reasonable, necessary and proper” because of the nature of the underlying property (farmland that could not be easily liquidated) and the benefits provided to the estate by the loan.

Estate of Saunders v. Comm’r, 136 T.C. No. 18 (April 28, 2011)

The primary issue in this case was whether a claim against an estate satisfied the requirements of IRS Reg. 20-2053-1(b)(3) (as in effect on the date the decedent’s death), which permits an estate tax deduction for a claim which, “though its exact amount is not then known,” is “ascertainable with reasonable certainty, and will be paid.” The Tax Court held that the value of the claim in question, as demonstrated by various expert reports, was too uncertain to be deducted as of the date of death; it also held that only the amounts that were actually paid during the administration of an estate were deductible under this section of the Regulations.

The claim in this case was a contingent liability of Gertrude Saunders’ husband, an attorney who had predeceased her by one year. At the time of his death, a $90 million lawsuit for legal malpractice, brought against him by the estate of a former client, was still ongoing. To settle his estate, the executors of the Estate of Gertrude Saunders made an agreement with the IRS that her estate would be responsible for the estate tax on the value of her husband’s malpractice claim at her date of death. The estate claimed a $30 million deduction for the malpractice claim and the IRS determined a deficiency of $14.4 million.

A jury found in favor of plaintiff in the malpractice action in 2007, but did not award any damages. The case was ultimately settled, with the estate paying attorneys’ fees of $250,000 and waiving its right to $289,000 in costs awarded in the state court judgment.

Although the Tax Court recognized that the Ninth Circuit Court of Appeals, to which this case is appealable, has ruled that subsequent events such as settlement agreements should be taken into account in the determination of contingent claims, the court focused here not on the settlement of the malpractice case but on the valuation reports provided by the estate. The first valuation report, filed with the estate tax return (two years before the case was settled) and prepared by the lead defense attorney in the malpractice action, valued the malpractice claim against the estate at $30 million. This attorney reasoned that, because of the wide range of variables, the potential recovery against the Estate was $90 million and that the likelihood of that recovery was between 25% and 50%. After the case was settled, the same attorney reduced his valuation to $25 million. A second defense attorney valued the claim at $22.5 million. An independent expert estimated the Estate’s liability to be $19.3 million because of the lack of assignability. In contrast, the IRS’s valuation expert stated that the claim had no merit, had “at most a 3% chance of recovery” and had a value between $25,449 and $1.5 million.

In its holding, the Tax Court stated that the widely varying valuations presented by the Estate were “prima facie indications of the lack of reasonable certainty” that the $30 million deduction claimed on the estate tax return -- or any specific lesser amount -- would be paid. It contrasted the variety of valuation methodologies used here with the credibility of actuarial tables used in earlier cases, and concluded that simply “stating and supporting a value is not equivalent to ascertaining a value with reasonable certainty.”

Estate of Foster v. Comm’r, T.C. Memo. 2011-95 (April 28, 2011)

As in Estate of Saunders v. Comm’r (see above), which the Tax Court decided on the same day, the primary issue in this case was the relevance of post-death events in valuation of an estate. One of the specific questions before
Transfer Tax Update, continued

the court here was whether the threat of litigation justified the discounting of the value of an asset in a decedent’s gross estate under IRC § 2053. The Court cited Saunders for the proposition that a “sharp discrepancy” among opinions for the same as well as the opposing side could establish a “lack of reasonable certainty in the values they suggest.” The court ultimately refused to accept the discounted valuation of the asset because the estate had failed to establish its value with reasonable certainty, as is required by Treas. Reg. § 20.2053-4.

Also, the court determined the value of the claims held by the estate and whether the estate was allowed to deduct its actual litigation expenses for those claims.

The decedent, Ellen Foster, died in May 2004. Her husband, Thomas Foster, founder of a successful mail-order horticulture business, had died in 1996. In 1991, he and his closely-held company agreed on a stock restriction plan, funded by a $50 million paid-up life insurance policy, whose terms required the company to repurchase the stock held by his family at his death. The company was forbidden by the agreement from encumbering the life insurance in any way. In 1995, the owners of the company instituted a leveraged employee stock ownership plan (ESOP), the funding of which necessitated taking out a $70 million unsecured loan. Mr. Foster sold 3.5 million shares of his company stock to the ESOP for $33.1 million.

When Mr. Foster died, the assets of his estate poured over into three marital trusts, all of which were administered by Northern Trust. Two years later, in 1998, at the company’s request, Northern Trust allowed the company to borrow money against the life insurance policy. The company filed for bankruptcy in 2001 and the life insurance policy was allowed to lapse. The ESOP beneficiaries then instituted a lawsuit against Mr. Foster’s estate for breach of fiduciary duty. The ESOP suit was settled by the estate in 2005. In 2008, the estate sued Kavanaugh, the attorney for Mr. Foster and the company, for malpractice and breach of fiduciary duty, and won a settlement of $850,000. That same year, the estate sued Northern Trust on a claim for breach of fiduciary duty and won $17 million.

Mrs. Foster’s estate filed an estate tax return in 2005, claiming a 32.4% discount on the marital trust assets because Northern Trust had frozen them. It did not include the potential claims against Kavanaugh and Northern Trust as assets of the estate. The IRS sent a notice of deficiency for $4.7 million. It disallowed the discount for the marital trust assets because the amounts were not “sums certain” and “legally enforceable” at decedent’s death, under Ninth Circuit case law, and, in the alternative, the discount was “not ascertainable with reasonable certainty” under Treas. Reg. § 20.2053-1(b)(3). The IRS later determined that the value of the potential claims should also be included as assets of the estate.

The Tax Court refused to allow a deduction for the potential claim against the estate from the ESOP litigation because the claim did not meet the “ascertainable with reasonable certainty” requirement under Treas. Reg. § 20.2053-1(b)(3). Next, the Court held that the estate was not entitled to discounts claimed on the frozen assets of marital trusts for lack of marketability and lack of control, because the restrictions on the sale of assets affected the trust beneficiaries and not to the value of the assets of the trusts. It reasoned that the rights of a purchaser of the assets would not be affected and that a purchaser would be able to resell the assets at an undiscounted price. The court also decided that the estate’s potential claims against Northern Trust and Kavanaugh should be included in the estate, but at a substantially discounted value.

Finally, the court held that the estate could deduct its actual expenses it incurred in litigating the claims against Northern Trust and Kavanaugh because those expenses had not already been factored into the valuation of the causes in action.

VALUATION


The Tax Court ruled that an estate’s valuations of two real properties and two paintings were correct.

The James J. Mitchell Trust owned a 95-percent interest and decedent James J. Mitchell, a California resident, owned a 5 percent interest in each of the properties, which consisted of a California oceanfront property and a 4,000 acre California ranch, both of which had been leased to third parties on a long term basis, and paintings by Frederick Remington and Charles Russell. James J. Mitchell’s estate filed an Estate Tax Return reporting an estate of $17 million and the IRS assessed a $10 million deficiency after revaluing all four assets.

The court reviewed the valuations of the assets presented by both the estate and the IRS and confirmed the estate’s valuations continued on Page 24
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in every instance. Using a “leased buyout” valuation method, the IRS assumed that the beachfront property was leased at a loss every year and estimated the value of a buyout of the lease. The IRS projected a 100% increase in the value of the ranch over 61 months. The court determined that this growth rate was “extreme” and accepted the 3.5% appreciation rate and 9.5% discount rate presented by the estate’s expert. The court held that the estate used the correct net income, actual expenses, and growth rate and stated that the income capitalization method was proper to use to value any income-generating property.

With respect to the artwork, both sides submitted the opinions of several appraisers. One painting was valued by the estate at $1.2 million and by the IRS at $2.3 million; the other painting was valued by the estate at $750,000 and by the IRS at $2 million. The estate’s three appraisers all had extensive experience valuing western artwork, but the IRS’s appraisers had no such experience. The court accepted the estate’s valuation, primarily because of the lack of expertise in western art on the part of the IRS appraisers. The court also rejected the use of private sales, presented without details of such sales, by the IRS appraisers.

**Estate of Giustina v. Comm’r, T.C. Memo. 2011-141 (June 22, 2011)**

After the IRS issued a notice of deficiency and assessed a $2.5 million accuracy-related penalty, the Tax Court used a combination of two methods to value the 41.128 percent limited partnership interest held by the Estate of Natale B. Giustina in a timberland company. Having applied a 40% discount for delays expected to be caused by the sale of the timberland, the court bifurcated its valuation, thereby assigning a 75% weight to the value under the discounted cash flow method and a 25% weight to the value under the asset method. The court then applied a 25% discount for lack of marketability to the DCF share and no discounts for lack of control or marketability to the 25% share.

The court concluded that the value of the estate’s interest was $27.5 million, instead of the $13 million reported by the estate. Because the reported value of the LP interest was less than 50 percent of the correct value, this would normally have been considered a substantial estate tax valuation understatement under IRC § 662. But since the executor had hired a lawyer to prepare the estate tax return and the lawyer had engaged the services of a professional appraiser to value the LP interest, the court ruled that in filing the return the executor reasonably relied on the appraisal and thus acted in good faith. The court concluded there was reasonable cause for the underpayment of tax and therefore refused to assess a penalty for substantial understatement of valuation.

**Estate of Gallagher V. Comm’r, T.C. Memo. 2011-148 (June 28, 2011)**

This is a business valuation case in which the court valued a decedent’s minority interest in an LLC.

The decedent, Louise Paxton Gallagher, died on July 5, 2004. At her death, her estate owned a 15% interest in Paxton Media Group, LLC (PMG), a company that owned 41 newspapers and publications. Her estate tax return stated that the LLC units had a fair market value (FMV) of $34.9 million. The IRS audited the return and claimed that the units should be valued at $49.5 million. After obtaining a subsequent appraisal valuing the units at $26.6 million, the estate petitioned the Tax Court for redetermination of the deficiency. Before the inception of the trial, the estate obtained a third valuation, at $28.2 million and the IRS obtained a second valuation, at $40.8 million.

The court reviewed the appraisals and determined that discount cash flow was the appropriate method of valuation. It rejected the “public guideline companies” method used by the IRS, because the companies chosen for comparison were not sufficiently similar to PMG.

The court agreed with the IRS in using financial data for the quarter ending on June 30, 2004, whereas the estate’s appraisal used financial data for the quarter ending on March 31. The estate argued that the data for the quarter ending on June 30 was not publicly available on the date of the decedent’s death, but the court stated that the estate could have ascertained this data by making inquiries.

Applying a 23 percent minority interest discount and a 31 percent marketability discount, the court finally arrived at a valuation of $32.6 million for the estate’s interest in the LLC. This was less than the amount originally reported on the estate tax return. In determining the marketability discount, the court used the restricted stock studies relied on by both parties’ experts, but stated that closely held entities should not rely on restricted stock studies because “owners of closely held stock held long term do not share the same marketability concerns as restricted stock owners with a holding period of two years.”

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IRS GUIDANCE


The IRS issued final regulations containing updated actuarial tables for valuing annuities, life estates, remainders and reversions. Generally speaking, these tables are effective for annuities, interests for life or for terms of years, and remainders and reversions valued on or after May 9, 2009. Under IRC § 7520(c)(3), the IRS must update the tables at least once every 10 years to reflect the most recent mortality data. These regulations adopt the temporary and proposed regulations issued in May, 2009, with only minor changes.

IRS Notice 2011-66 (August 5, 2011)

This Notice, which was released simultaneously with Rev. Proc. 2011-41 (see discussion below) has several functions: 1) it provides guidance on the procedures to be followed by estates of decedents dying in 2010 to make the election to apply the carryover basis rules in IRC §1022 (the “Section 1022 Election”) and addresses related issues; 2) it instructs donors in the election out of the automatic allocation of generation-skipping transfer (GST) tax exemption to direct skips in 2010; 3) it sets forth the due dates for 2010 taxable year returns that report GST, allocate GST exemptions, or opt out of the automatic allocation of GST exemption; and 4) it specifies how the GST tax is applied to 2010 testamentary transfers.

Executors of decedents’ estates who choose to make the Section 1022 Election must file Form 8939, Allocation of Increase in Basis for Property Acquired from a Decedent, by November 15, 2011. No extensions will be granted, except in rare situations. Form 8939 is to be published “early this fall.” The executor must report on the form all property acquired from the decedent except cash and §691 IRD property. (Noncitizens who are nonresidents report only U.S. assets.) The Section 1022 Election is irrevocable, and no conditional filings are allowed, i.e. filing of a Form 8939 that would be effective only if the assets exceed the decedent’s remaining unified credit amount. If no executor has been appointed, “any person in actual or constructive possession of property acquired from the decedent” may file Form 8939 for such property. The IRS anticipates that it may receive multiple Forms 8939 from parties wishing to claim a portion of an estate’s basis increase amount. In this case, the IRS will request that all such parties “collectively sign and file a single, restated Form 8939.” If the restated Form 8939 is not received within 90 days from the date of the IRS notification, the IRS will allocate the available basis increase.

Within 30 days of filing Form 8939, the executor must provide a statement to every recipient of property listed on that form setting forth the value and other information concerning such property required by IRC §6018(c).

Schedule R of Form 8939 must be attached to Form 8939 in order to allocate a 2010 decedent’s GST exemption when the executor makes the Section 1022 Election.

Donors wishing to elect out of the automatic allocation of GST exemption for gifts to inter vivos direct skips made in 2010 may describe the transfer and the election out on Form 709. The deadline for filing any return reporting a GST transfer made after 12/31/2009 and before 12/17/2010 is 9/19/11, including extensions, except in the case of a Schedule R attached to Form 8939. If the gift was made on or after 12/17/2010, the regular filing dates for Form 709 apply.


This Revenue Procedure, which was released simultaneously with IRS Notice 2011-66 (see discussion above), provides safe harbor rules for the application and interpretation of the modified carryover basis provisions in IRC §1022. It identifies property to which additional basis may not be allocated, which includes property received by the decedent less than three years before death either by gift or for less than full and adequate consideration (unless such property has been acquired from the decedent’s spouse). The Revenue Procedure also discusses how the amount of basis increase is determined, allocations of basis and increase, and determining the fair market value and holding period of assets to which IRC §1022 applies. There are special rules for community property.

IRC §1022 applies only the determination of the basis of property acquired from a decedent for which the executor makes the Section 1022 Election described in IRS Notice 2011-66. Such property is treated as being transferred by gift. When the executor makes a Section 1022 Election, IRC §1022 applies to determine the recipient’s basis in all property acquired from the decedent, continued on Page 26
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no matter when the recipient sells the property. However, the executor can allocate basis increase only to property acquired from and owned by the decedent (within the meaning of IRC §1022(d)) at death and only if decedent’s adjusted basis in such property is less than the fair market value of the property on the date of death. The basis of some property, such as IRD, is not determined by IRC §1022.

The term “property acquired from the decedent” under IRC §1022(e) means property acquired by bequest, devise or inheritance, or by the decedent’s estate from the decedent. It also refers to (a) property transferred by the decedent to a qualified revocable trust as defined in IRC §645; (b) any other trust for which the decedent reserved the power to alter, amend or terminate the trust; and (c) property passing from the decedent without consideration, such as property for which decedent held or exercised a general power of appointment when decedent did not create such power, property held in joint tenancy with right of survivorship or tenancy by the entirety, and the surviving spouse’s one-half interest in community property. “Property acquired from the decedent” does not include a decedent’s interest in a QTIP trust funded by a predeceased spouse.

The term “property owned by the decedent” under IRC §1022(d) includes (a) property titled in the decedent’s name at death, and not held by the decedent solely in a legal or representative capacity; (2) jointly owned property; (3) property placed by the decedent in a qualified revocable trust as defined in IRC §645(b)(1); and (4) certain community property. In contrast, property over which the decedent holds a power of appointment is not considered to be owned by the decedent at death. Property transferred to a trust by the decedent in which the decedent retained a power to alter, amend or terminate the trust is not considered property owned by the decedent. Property transferred to a trust in which the decedent retained an income interest is not considered to be owned by the decedent solely because of the retained income interest. Finally, the fact that property has been transferred to a foreign trust by a U.S. grantor is not sufficient to result in the grantor’s being considered the owner at his or her death.

However, if the terms of any of these types of trusts require that the trust property revert back to the decedent upon death, such property is deemed to be owned by the decedent. But a decedent is not considered to be the owner of an interest in a QTIP trust.

The amount of basis increase is calculated as the sum of the General Basis Increase (which in turn is calculated as the Aggregate Basis Increase and the Carryovers/Unrealized Losses Increase) IRC §1022(b) and the Spousal Property Basis Increase under IRC §1022(c). The Aggregate Basis increase is $1,300,000. The Carryovers/Unrealized Losses Increase is calculated as the sum of (i) capital loss carryovers that, but for the decedent’s death, would have been allowable under IRC §165(c)(1) and (c)(2) if the property had been sold at fair market value immediately before the decedent’s death.

The Spousal Property Basis Increase of $3,000,000 can be allocated to any property owned by and acquired from the decedent that satisfies the definition of qualified spousal property under IRC §1022(c) (3). Such property can be either property transferred outright to the surviving spouse or QTIP property. The Spousal Property Basis increase can be allocated to property held in a testamentary charitable remainder trust.

The amount of the Aggregate Basis Increase is limited to $60,000 for nonresident decedents who were not U.S. Citizens and is not increased by the Carryovers/Unrealized Losses Increase.

Section 1022 Basis Increase can be allocated on a property-by-property basis to property owned by and acquired from the decedent whose adjusted basis after the allocation does not exceed the fair market value at the decedent’s death. Basis Increase may be allocated to property even after the executor has disposed of it. Basis increase may not be allocated to separate interests in property created by the decedent’s death, such as when property owned outright by a decedent is divided into a life estate interest and a remainder interest by reason of his/her death.

For purposes of IRC §1022 the fair market value of property acquired by a decedent dying in 2010 is determined in the same manner as it is determined for the estate tax.

The holding period of a recipient’s basis in property acquired from a decedent includes the period during which the decedent held the property. The tax character is determined in the same way as the holding period. The recipient of property acquired from a decedent
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that is depreciable property in the hands of the recipient is treated as the decedent for the portion of the recipient’s basis in the property that equals the decedent’s adjusted basis therein, i.e. the recipient uses the decedent’s depreciation method, recovery period and convention applicable to the property. If the executor applies Basis Increase to the property, for depreciation purposes such Basis Increase is treated as a separate asset placed in service on the day after the decedent’s date of death.

Unused passive activity losses can be added to the basis of the decedent’s property, in keeping with the provisions of IRC §469(j)(6). Because property owned by the decedent at death is considered to be treated under §1022 as having been transferred by gift, IRC §469(j)(6) applies. It provides that property with respect to which a person has a suspended passive loss is transferred by gift and the amount of the suspended loss is added to the basis of the transferred property. The basis increase is deemed to take place just before the decedent’s death.

If appreciated property is distributed from an estate or trust to satisfy a pecuniary bequest or its equivalent, gain is recognized by the estate or trust to the extent that the property has appreciated above its fair market value as of the decedent’s date of death. This rule applies to qualified revocable trusts and to trusts that would have been included in the decedent’s gross estate under IRC §2036, §2037 or §2038 if the Section 1022 Election had not been made.

In the case of transfers to nonresident aliens, any basis increase allocated to an asset under IRC §1022 may be considered in the calculation of the amount of gain recognized on the transfer under IRC §684.

A testamentary charitable remainder trust that otherwise qualifies as a charitable remainder trust under IRC §664 continue to be qualified under IRC §664 if the decedent’s executor makes a Section 1022 Election, even though no deduction under IRC §2055 is available for transfers to such a trust.

II. GIFT TAX FORMULA CLAUSES

*Hendrix v. Comm’r*, T.C. Memo. 2011-133 (June 15, 2011)

The Tax Court ruled that the defined value formula clauses in an assignment agreement properly set the fair market value of nonpublicly traded corporate stock transferred by the petitioners to various family trusts and to a charitable foundation. The Court determined that the formula clauses were reached at arm’s length and were not contrary to public policy.

The petitioners, a married couple, formed an S corporation consisting of nonvoting and voting common stock. In late 1999, the husband and wife each decided to give 287,619.64 shares of nonvoting stock to GST trusts to their daughters and to a donor-advised fund at a nonprofit community organization (the “Foundation”). Using the appraised value of $36.66 per share, the petitioners executed agreements assigning shares of nonvoting stock to a fair market value of $10.5 million to the trustees of the assignor’s trust and any remaining shares to the Donor-Advised Fund. The trusts were required to pay any gift taxes. On the same day, the petitioners executed a second set of assignment agreements transferring 155,622.21 shares of nonvoting stock to issue trusts for the benefit of the daughters and to the Foundation. The fair market value of the shares transferred to the trusts was $4.2 million, and the trustees of each trust gave a note to each assignor for $3.6 million. The Foundation and the trusts were granted ownership of the assigned shares as tenants in common. The petitioners stipulated that if the defined value formula clauses in the assignment agreements are judged not to control the valuation of the shares, such shares were to be valued at $48.60 per share.

The Comm’r disputed the validity of the formula clause, claiming that the value of the stock was $48.60 per share and that the deductible charitable contribution of each petitioners was $66,284.57 instead of the $50,000 that was claimed.

The Court found that *McCord v. Comm’r*, 461 F.3d 614 (5th Cir. 2006), in which the same type of formula clause was employed, was controlling precedent on all points except for the Commissioner’s claims, not addressed in *McCord*, that the formula clauses were not the result of an arm’s length transaction and that they were void as contrary to public policy.

The Court held that the formula clause was reached at arm’s length for several reasons: first, the structure of the transaction as part sale/part gift meant that even though the trusts for the benefit of the petitioners’ daughters would benefit from the transfers, these trusts would still incur the economic and business risk of being buyers of a portion of shares of stock whose value was subject to

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change. Secondly, the court found no collusion between the petitioners and the Foundation. The petitioners demonstrated their lifetime practice of making charitable gifts and the Foundation was represented by independent counsel and conducted an independent appraisal.

The petitioners successfully argued that the formula clause was not void as contrary to public policy because the Court ruled that, unlike the saving provision in Comm’r v. Procter, 142 F.2d 824 (4th Cir. 1944), it did not impose a condition subsequent that could defeat the gift. Moreover, the Court stated that it actually favored public policy by encouraging gifts to charities.


The Ninth Circuit affirmed the Tax Court’s decision (T.C. Memo. 2009-280, December 9, 2009) that the taxpayer was entitled to a charitable deduction for additional units received by a charitable foundation after an IRS audit determined that the units had initially been undervalued.

Anne Petter, a wealthy heiress, created the Petter Family LLC (PFLLC) and transferred $22.6 M of UPS stock into it. In 2002, she transferred PFLLC units in part-gift and part-sale transactions to intentionally defective grantor trusts for her children. The sales transactions considered of sales of units in exchange for promissory notes. The number of units gifted to each trust was determined by a formula: the gift transfers consisted of assets up to the maximum amount that could pass free of gift tax, with any excess amounts to be distributed to designated charitable organizations. Also, the parties agreed to reallocate the PFLLC units among themselves if, as a result of a valuation dispute with the IRS, either trust received more units than it was entitled to receive based on the value of the gift as finally determined for gift tax purposes. The donor engaged a valuation firm to determine the fair market value of the membership units as of the transfer date. The firm determined that the fair market value of the membership units was $536.20 per unit.

On her gift tax return the donor reported a 46% discount for non-marketable and a 15.3% discount because of the use of a closed-end fund. The IRS audited the return and determined that the discount should be 29.2% and that the fair market value of the units was $794.39 per unit. The increased share valuation claimed by the IRS resulted in a much larger gift to one of the charities. The parties agreed on an overall 35% discount.

The IRS argued that the gifts to the foundations were subject to a condition precedent under Treas. Reg. § 25.2522(c)-3(b)(1), which provides that no charitable deduction is allowed “[i]f, as of the date of the gift, a transfer for charitable purposes is dependent upon the performance of some act or if the happening of a precedent event in order that [the transfer] might become effective.” It argued that the audit served as a condition precedent for the transfer of the additional LLC units to the charities, and therefore disallowed the additional charitable deduction that the Estate claimed as a result of the reallocation of units between the trusts and the foundation that was made necessary by the audit. It also argued that, under IRC § 2001(f)(2), the value of the gift, and thus the amount passing to the foundations, was fixed by the value reported on the gift tax return.

Any action on the part of the IRS to change that value should therefore be considered a subsequent action and condition precedent to the increased amount passing to the foundations.

The Ninth Circuit held that the Tax Court properly determined that the gifts to the foundations were not subject to a condition precedent, that the charitable deduction was appropriate and that no additional gift tax was due. It stated that the transfers to the foundations became effective immediately upon the execution of the transfer documents and the delivery of the PFLLC units. Both before and after the audit the foundations were entitled to receive the same number of units: the “clauses merely enforce the foundations’ rights to receive a pre-defined number of units...Thus, the IRS’s determination...in no way grants the foundations rights to receive additional units.” The only question left open after the transfer was the value of the units transferred.

The Ninth Circuit also rejected the IRS’s argument that the value as finally determined for gift tax purposes was the value shown on the gift tax return unless the IRS contested such value on audit. It reasoned that IRC § 2001(f)(2) relates to the determination of values only after the expiration of the period of assessment of tax and does not apply to determination of value for other gift tax purposes.

It is also noteworthy that on appeal the IRS did not assert the public policy arguments it had made to the Tax Court.

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DISCLAIMERS

**Tatum v. United States, No. 10-60852 (5th Cir. Aug. 8, 2011)**

In an unpublished opinion, the Fifth Circuit overturned the District Court’s grant of summary judgment to the IRS (see **Tatum v. United States**, United States District Court, S.D. Mississippi, October 6, 2010, summarized in our December 2010 Tax Update) and held that a decedent’s disclaimer of a bequest from his parent, which resulted in the passing of the disclaimed property to the decedent’s children, was a qualified disclaimer and not a gift that resulted in gift tax liability to the decedent’s estate or to his wife’s estate. Finding that both according to the Mississippi anti-lapse statute and the testator’s intent the disclaimed property would pass without any direction on the decedent’s part, the court ordered the refund of the gift tax and penalties paid by the grandchildren.
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