Report of the Chair

By HOWARD I. VERBOFSKY
PNC BANK

Included in the many works of the Section over the past few months was a resolution of the Executive Committee seeking the repeal of the Pennsylvania statute that decoupled Penn-sylvania’s estate tax from the federal estate tax state death tax credit. The Philadelphia Bar Association Board of Governors adopted the Section’s resolution, which was co-sponsored by the Tax Section. The resources of the Bar Association, including its Harrisburg lobbyist, are now available to support the effort. The initiative was spearheaded by Ralph Teeters, Bernice Koplin and Kathleen Stephenson, and Kathleen and Bernice have already started working with the Association’s lobbyist.¹

The Section also completed another very important task recently when the Nominating Committee (Chair Ned Donoghue, Larry Barth, Gene Gillin, Paul Heintz and Margaret Sager) nominated next year’s Vice Chair, Secretary and new Executive Committee members.

You should note that the Nominating Committee consisted exclusively of past Section Chairs. Ralph Teeters, who is the Section’s Board of Governors Representative and was mentioned above as being one of the driving forces behind the anti-decoupling effort, also is a past Chair. In my remarks at the recent Quarterly Meeting/CLE Program, I mentioned many other instances where past Chairs have continued to serve the Section. I will not repeat here all those instances, but I will reiterate the Section’s gratitude to these past Chairs.

As a soon-to-be-past-Chair myself, I note that in the rush of current-year activities as Chair, I found it difficult to look ahead. Let me do that now, and lay out a few

¹EDITOR’S NOTE: I am pleased to report that not long after the Report of the Chair was submitted, the anti-decoupling effort achieved complete success with the Governor’s signing H.B. 200

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Valuation Issues in Planning with Life Insurance

By ROBERT H. LOUIS
SAUL EWING LLP

Many planning techniques are based upon the purchase and transfer of life insurance contracts. The three general areas in which these techniques occur are gifts, compensation and retirement plans. Generally, the purpose of these techniques is to accomplish a transfer of policy value that, for tax reporting purposes, is significantly lower than the amount paid to acquire such value.

This issue reached the United States Supreme Court more than sixty years ago, in two cases decided the same day. In Guggenheim v. Rasquin, 312 U.S. 254 (1941), the taxpayer paid a one-time premium of $852,438.50 for insurance policies and transferred them, at about the same time, to her children, using as their gift tax return value the cash surrender value of a much lesser amount. Justice Douglas stated: "Certainly the petitioner here did not expend $852,438.50 to make an immediate gift limited to $717,344.81." (312 U.S. at 257-58). In that case and its companion, U.S. v. Ryerson, 312 U.S. 260 (1941), the value of the policies transferred was held to be the cost of replacing them.

The regulations that have been issued dealing with the valuation of life insurance policies in gift, compensation and retirement plan situations have followed different paths. The gift tax regulation is contained in Treasury Regulation Section 25.2512-6(a). (Similar rules are set forth in estate tax situations by Treasury Regulation Section 20.2031-8.) As a basic rule, the regulation indicates that the value of a life insurance contract is established through the sale of comparable contracts by the insurance company. Once the policy to be valued has been in force for a number of years, that method of valuation might no longer be appropriate, in which case the regulation uses the concept of interpolated terminal reserve. The reserve of a policy is the amount that, with future net premiums and interest, will be sufficient to pay future claims; the terminal reserve is that amount calculated at the end of a policy year; and the interpolated terminal reserve is the calculation made during the policy year. The regulation notes that the interpolated terminal reserve might not yield the correct value if there were something of an unusual nature that does not result in determination of the full value of a policy.

One example where the interpolated terminal reserve might not produce an appropriate value could be where the insured is in poor health, and collection of the insurance proceeds in the near future likely. Such a circumstance occurred in Pritchard v. Comm' r, 5 T. C. 204 (1944). Another area where an interpolated terminal reserve calculation might not work is in newer types of policies, such as universal life policies. In those situations, different types of insurance company reserves, such as fund value or reserve value, could be an appropriate measure. In some instances, these measures - interpolated terminal reserve, fund value, and reserve value - might be very similar to cash surrender value. However, cash surrender value by itself should not be viewed as the determinant of fair market value because the ability to surrender an insurance policy and receive a cash payment is just one attribute of the policy. The ability to borrow against policy values and the right to collect the proceeds at death are also elements of value.

In compensatory situations, the regulations under Code Section 83 apply. Treasury Regulation Section 1.83-3(e) states that, in determining the amount of property received as compensation when life insurance is transferred, "only the cash surrender value of the contract is considered to be property." This rule is clearly very different from that in gift and estate tax transactions. Several commentators have questioned the validity of this valuation method. See, Wolk, Brown & Sevilla, "What is the Value of Life Insurance for Income and Gift Tax Purposes", 136 Trusts & Est., No. 6, p. 27 (June 1997) and Leimbarg, "Policies for Valuation of Life Insurance", 139 Trusts & Est., No. 3, p. 46 (Mar. 2000).

Finally, in retirement plan situations, another regulation is applicable. Treasury Regulation Section 1.402(a)-1(2) provides that if a qualified retirement plan distributes an insurance policy to a participant, the amount of income recognized is the "entire cash value" of the policy. That term is not defined, and some planners have assumed that it is the same as cash surrender value. The Internal Revenue Service began taking notice of this issue and issued guidance in Notice 89-49, 1989-2 CB 165. This notice stated that the entire cash value of an insurance policy is the cash surrender value of the policy, unless it is found that the participant is not entitled to receive more than the cash surrender value because of the terms of the plan.
Valuation Issues, continued

of possible abuses in this area a number of years ago. In Announcement 88-51, 1988-13 I.R.B. 34 and Notice 89-25, 1989-1 C.B. 662, doubts were raised about the use of cash surrender value. However, in Prohibited Transaction Exemptions 92-5 and 92-6, 57 Fed. Reg. 5019 and 5189 (2/11/92), the Department of Labor suggested that cash surrender value could be the measure of value under certain circumstances. Again, some planners have relied upon these pronouncements to propose transactions in which plan account balances are used to purchase life insurance, followed in a subsequent year by distribution of the policy with a value equal to its much smaller cash surrender value. In that way, a large amount of taxable income within the plan is distributed at a very low tax cost; after which, the policy continues to grow in value. This seems as inappropriate a measure of real value as it did to Justice Douglas in 1941.

More recently, industry sources have predicted that the Internal Revenue Service will shortly issue new regulations to deal with issues arising in the distribution of life insurance policies from qualified plans. When new regulations are issued, they should focus on methods to ascertain the best estimate of fair market value possible within the context of the wide range of insurance policy types and the varying circumstances in which they are used. It seems likely that those methods will be more similar to the existing gift tax regulations than the compensation or retirement plan regulations.

A Primer on Hedging Strategies

By JULIA B. FISHER
JPMORGAN PRIVATE BANK

An investor may accumulate a large single stock position as a result of selling a private company to a publicly traded company, taking a company public through an initial public offering, receiving options or restricted stock as part of a compensation package, or by inheritance. As a result, the investor may have a large portion of his or her overall wealth in a single concentrated stock position, which can be subject to significant volatility as a result of market movements. Most investors would prefer to hold a diversified portfolio, which often provides attractive returns with lower volatility than a single stock position. However, many investors would prefer not to sell stock if the sale would trigger large embedded capital gains.

This article provides a basic overview of some of the different strategies that are available to the individual investor who is interested in hedging a single stock position while deferring taxes and potentially gaining liquidity to allow for diversification. The strategies discussed are based on the use of options, and for purposes of this article an “option” is defined as a derivative (either OTC or listed) that gives the holder the right, but not the obligation, to buy or sell an underlying security at a certain price for a limited period of time. OTC is short for “over-the-counter,” which means that the option contract is privately negotiated between parties with terms tailored to the investor’s objectives. The parties to an OTC derivative are the investor and a financial institution acting as a “counterparty.” In contrast, a listed option contract is executed through an exchange, such as the Chicago Board Options Exchange, with the Options Clearing Corporation as the option counterparty. This article will discuss only the application of OTC options.

The following glossary may be helpful.

Call: An option contract that gives the holder the right, but not the obligation, to buy the underlying security at a specified price for a certain fixed period of time.

Collar: A structure that consists of a long put and short call (which requires the investor to give up some upside in the stock), so that the economic exposure of the investor is essentially the stock price restricted to the range between the put strike and the call strike.

Covered call: The sale by an investor of a call on a security he or she already owns.

Derivative: A financial instrument whose...
Hedging Strategies, continued

value is determined from the value and characteristics of an underlying security (in our case, an equity).

Exercise: The act of exchanging the underlying stock for the strike price (for a put) or exchanging the strike price for the underlying stock (for a call).

Long and short positions: A long position is ownership of the underlying asset, and can also refer to the holder of an option who has the right to buy or sell the underlying stock. A seller of an option who has potential liability is "short" that position.

Maturity: The term of a derivatives contract.

Put: An option contract that gives the holder the right, but not the obligation, to sell the underlying security at a specified price for a certain fixed period of time.

Settlement: When the investor has paid the broker for securities bought or when the investor delivers securities that have been sold and the investor receives the proceeds from the sale. There are generally two types of settlement: a cash-settled option involves no exchange of securities, but instead an economically equivalent cash transfer upon exercise, while a physically-settled option involves an actual exchange of securities when exercised.

What is a put option?

An investor holding a concentrated stock position may be concerned about a significant price decline in his or her stock position. A simple solution for the investor's concern is buying a put option. In this situation, the investor would pay the counterparty an up-front premium, and, in exchange, the investor would receive the right to effectively sell his or her shares to the counterparty at some predetermined price (the "put strike") at some future date ("maturity date"). By purchasing a put option, the investor is effectively insuring the position below the put strike. At maturity, if the stock price is below the put strike, then the counterparty will pay the investor the difference between the put strike and the stock price. If the stock price is at or above the put strike at maturity, then the investor will lose 100% of the premium paid. During the term of the transaction, the investor retains all dividends and appreciation in the stock.

Example of a hypothetical put option

Anne Investor owns 100,000 shares of ABC stock, which have a low tax basis and have appreciated significantly. The stock is currently trading at $100 per share and Anne wants to "lock in" the current stock price for a year. Anne can buy a one-year OTC put option with a strike price of $100 for an up-front premium of $10 (10% of the stock value).

At maturity one year later, if the stock is at or above $100, Anne would not exercise the put. If the stock is below $100, Anne would exercise the put and receive the difference between the value of the stock and $100. If the stock is at $80, Anne will receive $20.

What is a put spread?

An alternative strategy for an investor who is interested in protecting the value of his or her stock but wants to reduce the amount of the up-front premium is the put spread strategy. A put spread, which consists of a simultaneous purchase of a "higher put strike" and sale of another put with a "lower put strike", limits the investor's payout to the range defined by the two put strikes.

Example of a hypothetical put spread

Anne Investor owns 100,000 shares of ABC stock and wants to protect the value of her stock position, but does not believe that the stock will depreciate more than 30%. The stock is currently trading at $100 per share. Anne purchases a put spread with the "higher put strike" at 100% of the current market price and the "lower put strike" at 70% of the current stock price. Anne pays a $5 premium (5% of the stock price) for a one-year OTC put spread.

At maturity (one year later) one of the following scenarios can occur:

If the stock is between the put strikes, the counterparty will pay Anne the difference between the higher put strike and the stock price. If the stock is at $90, Anne will receive $10.

If the stock is below the lower put strike, the counterparty will

continued on page 6
Hedging Strategies, continued

pay the difference between the two put strikes. If the stock is at $60, Anne will receive $30.

If the stock is at or above the higher put strike, Anne will receive no payment and lose 100% of the premium paid.

What is a cashless collar?

Many investors are concerned about their single stock position but do not want to pay the premium for a put or put spread option. Another alternative that the investor may want to consider is the cashless collar strategy. In structuring a cashless collar, the investor purchases a put option from the counterparty that protects the stock from any decline below a predetermined price (the “put strike”) for a certain time period. To finance the put protection, the investor sells a call option, which gives away the appreciation in his or her stock above a predetermined stock price (the “call strike”). This structure essentially locks in the value of the stock to a price range (or collar) with no up-front premium due either party.

Example of a hypothetical cashless collar

Anne Investor owns 100,000 shares of ABC stock that have appreciated considerably and are currently trading at $100 per share. Anne is interested in protecting the value of the stock position and is willing to limit the upside stock price appreciation. Anne can buy a two-year OTC put option with a strike price of $90 (90% of the current stock price) for two years and no premium is owed by either party.

At maturity (two years later) one of the following scenarios can occur:

If the stock price is below the put strike, the counterparty will pay Anne the difference between the put strike and the stock price. If the stock is at $60, Anne will receive $30.

If the stock price is above the call strike, Anne will pay the counterparty the difference between the call strike and the stock price. If the stock is at $140, Anne will pay $5.

If the stock price is between the put strike and call strike price (between $90 and $135 in the example), both options expire worthless and no payments are exchanged.

What is covered call writing?

An investor who has a neutral view on his or her stock position and is interested in enhancing the stock return may want to consider writing call options on his or her single stock position. By selling a call option, the investor receives an up-front premium, and in exchange, agrees to give away potential appreciation in the stock position above a predetermined stock price (the “call strike”) until some future date (“maturity date”). At maturity, if the stock price is above the call strike price, the investor will pay the counterparty the difference between the final stock price and the call strike. The investor retains all appreciation in the stock up to the call strike.

An investor’s call strike can be set at any level, according to his or her risk preference and view on the stock. An investor who sells a call option in the underlying stock gives up any appreciation in the stock price above the strike price and remains exposed to the downside of the underlying stock in return for the receipt of the option premium. The investor will be required to post collateral for this transaction, which typically is in the form of the underlying stock.

Example of a hypothetical call option

Anne Investor owns 100,000 shares of ABC stock that have appreciated considerably. Anne believes that the stock has limited short-term appreciation potential and she is interested in generating income. The stock is currently trading at $100 per share. Anne can sell a six-month OTC call option with a strike price of $110 for an up-front premium of $10.

At maturity (six months later) one of the following scenarios can occur:

If the stock price is above the call strike price, Anne will pay the counterparty the difference between the final stock price and the call strike. If the stock is at $120 Anne will pay the counterparty the call value of $10.

If the stock is at or below the call strike price, the call expires worthless and Anne makes no payments.

What is a pre-paid variable forward contract?

In its simplest form, a pre-paid variable forward contract protects against the risk that the
Hedging Strategies, continued

value of the investor’s stock will fall, and provides an up-front cash payment to the investor. In many respects, it is comparable to a collar plus a loan. The investor who enters into a pre-paid variable forward contract agrees to sell a varying number of shares of stock to the counterparty at maturity. The initial payment to the investor at the outset of the transaction may range from 75% to 90% of the current stock value and is net of borrowing costs. The transaction protects the stock position below the hedged value and gives the investor appreciation potential up to a set limit. The investor keeps dividends and voting rights during the term of the contract.

The number of shares to be delivered at the end of the contract is determined by the share price at the end of the contract. The maximum shares to be delivered never exceeds the number of shares on which the up-front payment was based. The forward sale can be settled with cash rather than shares if the investor chooses. The underlying shares are posted as collateral for initial payment.

Example of a hypothetical pre-paid variable forward contract

Anne Investor has a concentrated equity position that is currently trading at $100 per share and she would like to diversify the portfolio, but does not want to trigger a taxable event by selling stock. Anne can enter into a two-year pre-paid variable forward contract in which the hedged value is set at $100 and the upside limit is $120. By entering into a pre-paid variable forward contract, Anne has protected her stock from falling below $100 and will retain 20% upside on the stock over the two years. Anne will receive 85% of the current stock price at the beginning of the transaction, which she can use to invest in a diversified portfolio. On the maturity date, Anne will deliver shares (or the cash equivalent) to settle the obligation of the pre-paid variable forward contract.

At maturity (two years later) one of the following scenarios can occur:

If the stock price is equal to or less than the hedged value at maturity, the market value of the stock is deliverable.

If the hedged value is less than the stock price at maturity and equal to or less than the upside limit of appreciation, the hedged value of the shares is deliverable; the investor keeps any "residual" amount between the hedged value and the upside limit.

If the stock price at maturity is greater than the upside limit, the hedged value of the shares plus appreciation above the upside limit is deliverable; the investor keeps any "residual" amount between the hedged value and the upside limit.

The consequences resulting from each scenario can be summarized as follows:

<table>
<thead>
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<th>Stock Price at Maturity</th>
<th>Shares Delivered</th>
<th>Optional Cash Delivery</th>
<th>Residual</th>
</tr>
</thead>
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<td>100%</td>
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<td>83.33%</td>
<td>$10,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>$130</td>
<td>84.65%</td>
<td>$11,000,000</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

Conclusion

These strategies are not appropriate for everyone, and the most appropriate strategy for an investor will depend on several factors, including the investor’s overall asset allocation, risk tolerance, tax situation, and regulatory constraints (e.g. the investor’s status as a corporate insider or affiliate). OTC derivative strategies allow the investor considerable flexibility in setting the strike price, maturity date and other terms and conditions of the strategy. As a consequence, there are many variations on the basic strategies discussed in this article.
Minimizing Income Taxation of Trust Income: The Delaware Advantage

By THOMAS R. PULSIFER AND TODD A. FLUBACHER
MORRIS, NICHOLS, ARSH & TUNNELL.¹

Many tax planners may not be aware that Delaware law can create opportunities for clients to employ Delaware trusts to reduce or eliminate the state income taxes applicable to their trusts. Many states have adopted income taxation systems that tax trusts based on whether the trust is a resident or nonresident trust, as determined by the residence of the grantor and/or trustee. Delaware law takes this approach. However, Delaware law also includes some unique features that can enable grantors in other states to use Delaware trusts to minimize or avoid state income taxes.

A. Delaware Tax Law

Delaware follows the federal income tax rules for determining whether a trust is a grantor or non-grantor trust. If a trust is a “grantor trust,” then similar to the federal tax system, the trust is disregarded as a separate taxpayer under Delaware law and the income will be taxed to the grantor. Delaware treats “non-grantor trusts” as separate taxing entities and further categorizes them as either resident or nonresident trusts for Delaware state income tax purposes.

A non-grantor trust is a Delaware resident trust if (1) the trust is created by the will of a decedent who at death was domiciled in Delaware; (2) the trust is created by a person domiciled in Delaware; (3) during more than half of any taxable year, the trust has only one trustee who is either a Delaware resident individual or an entity conducting trust business in an office in Delaware; (4) during more than half of any taxable year, the trust has more than one trustee and one of the trustees is an entity conducting trust business in an office in Delaware; or (5) during more than half of any taxable year, the trust has more than one trustee all of whom are individuals and at least one-half of whom are Delaware residents.² Delaware resident trusts are potentially subject to the Delaware income tax imposed upon individuals, however, several deductions may limit or eliminate this potential tax liability. Resident trusts may take an income tax deduction for both the amount of their federal distributable net income that is actually distributed³ and the amount of their federal taxable income (including capital gains), as modified for Delaware purposes, that is set aside for future distribution to nonresident beneficiaries.⁴ Consequently, a Delaware non-grantor resident trust will be subject to the Delaware state income tax only on its income that is set aside for future distribution to Delaware resident beneficiaries.

All non-grantor trusts that do not satisfy the definition of a resident trust are nonresident trusts for Delaware income tax purposes.⁵ Nonresident trusts and their nonresident beneficiaries are subject to Delaware income taxation only on the portion of the trust’s income taxable to them that is derived from Delaware sources.⁶

B. Categorizing Other States’ Income Taxation of Trusts

The tax laws of states other than Delaware may generally be divided into three categories based on the nature and strength of the connection between a trust and the state that is required in order to impose its income tax on the trust. Many states have laws, similar to Delaware’s law described above, that define trusts as either resident or nonresident trusts; such states generally tax all of the taxable income of resident trusts while taxing nonresident trusts only on their income derived from sources within the state. States have adopted various approaches to what type of connection between the state and the trust will classify the trust as a resident trust. In some states, resident trusts include those created by a grantor who was domiciled in the state at the time of his or her death or when the trust became irrevocable. Many of those states purport to impose a tax on all of a resident trust’s income throughout its existence, even though the trustee, all of the beneficiaries, and the trust assets may be located outside the

¹ The authors would like to express their appreciation to Christie Di Guglielmo for her contribution to this article.
² 30 Del. C. §1136(a).
³ 30 Del. C. §1137.
⁴ 30 Del. C. §1138.
⁵ 30 Del. C. §1136(b).
⁶ 30 Del. C. §1141.

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Delaware Advantage, continued

state. Other states require a more substantial ongoing link between the trust and the state in order to classify the trust as a resident trust and therefore impose tax on income from sources outside the state. Finally, a few states define a trust’s residence based on the domicile of the trustees or beneficiaries.

1. States Taxing Income of Trusts Only When There Remains a Significant Ongoing Link Between the Trust and the State

States with tax laws requiring some significant current link between a trust and the state in order to subject the trust to state income tax include New York, New Jersey, Massachusetts, Michigan and Missouri. New York law will serve as an example of how such states tax trusts. New York generally imposes income tax on all the income of New York resident trusts.7 Very generally, a New York resident trust is a trust created by the will of a New York decedent or inter vivos trust agreement of a person domiciled in New York at the time the trust was created or became irrevocable. However, in Mercantile-Safe Deposit & Trust Co. v. Murphy, 203 N.E.2d 490 (N.Y. 1964), the New York Court of Appeals held that constitutional limitations restrict the state’s ability to tax resident trusts with minimal current contacts with the state. In response, New York revised its tax regulations to create a safe harbor for trusts with few New York connections, providing explicitly that New York will not impose a state income tax on a trust if (1) all of the trustees are domiciled in a state other than New York; (2) the entire corpus of the trust, including real and tangible property, is located outside of New York; and (3) all income and gains of the trust are derived from non-New York sources, determined as if the trust were a nonresident trust.8

2. States Taxing the Income of Trusts Based on a Minimal Nexus with the State

Some jurisdictions, such as Pennsylvania, Connecticut, Ohio and the District of Columbia, require only a minimal nexus with a trust in order to impose state income tax on the trust. Pennsylvania imposes a tax on all the income of resident trusts and on all the income from Pennsylvania sources of nonresident trusts.9 A Pennsylvania resident trust is a trust (1) created by the will of a decedent who resided in Pennsylvania at the time of his or her death, or (2) created by or consisting in whole or in part of property transferred to a trust by an individual residing in Pennsylvania.10 Under Pennsylvania law, the accumulated income of a resident trust will be subject to Pennsylvania tax regardless of whether the trust has any current contacts with Pennsylvania. This is true even if the trust was created under the laws of another state, and all of the trustees, the administration of the trust, and all of the beneficiaries are located outside of Pennsylvania. The tax is imposed simply by virtue of the grantor’s residence (or death as a resident) in Pennsylvania at the time of creation of the trust.

Courts in several jurisdictions with tax systems similar to Pennsylvania’s have considered and upheld the constitutionality of taxing trusts with such minimal connections to the jurisdiction. In Chase Manhattan Bank v. Gavin,11 the Connecticut Supreme Court upheld the constitutionality of a Connecticut law imposing an income tax on trusts based solely on the fact that the grantors resided in Connecticut at the time the trusts were created. The court reasoned that the trusts were initially created under Connecticut laws and the Connecticut courts were “open and available” for accounting and trust administration. In District of Columbia v. Chase Manhattan Bank,12 the District of Columbia Court of Appeals also upheld the constitutionality of a law that taxed the income of a testamentary trust created by the will of an individual who died while domiciled in the District of Columbia even though the trustee, trust assets, and trust beneficiaries were all located elsewhere. Essential to the court’s holding was the fact that D.C. courts had a “continuing supervisory relationship” with respect to the administration of the trust and that even though another state may assert jurisdiction over the trust, the D.C. court may also retain jurisdiction, and the District’s power to exercise jurisdiction over a trust is coextensive

7 N.Y. Tax Law §601(c) (Consol. 2003).
9 72 P.S. §7302 (2002).
10 Id. §7301(s); see also 61 Pa. Code §101.1 (2003) (“The single controlling fact in determining if a trust is a resident trust . . . shall be whether the decedent, the person creating the trust or the person transferring the property was a resident individual or person at the time of death, creation of the trust or the transfer of the property. The residence of the fiduciary and the beneficiaries of the trust shall be immaterial.”).
11 733 A.2d 782 (Conn. 1999).
12 689 A.2d 539 (D.C. Cir. 1997).
Delaware Advantage, continued

with its power to tax it.13

The courts in *Gavin* and *Chase Manhattan* essentially based their opinions on the premise that the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*14 allowed a state to tax based on very limited contacts with the state. In *Quill*, the U.S. Supreme Court upheld a use tax statute under the Due Process Clause, ruling that a state may tax a taxpayer who has "minimum contacts" with the taxing state – essentially imposing the same test for state taxation under the Due Process Clause as it has traditionally applied to questions of state court jurisdiction over nonresidents.

Several states' courts have reached differing conclusions regarding the constitutionality of income tax statutes that are substantially similar. These inconsistencies have yet to be definitively resolved by the federal courts. Several commentators suggest that *Gavin* and *Chase Manhattan* were clearly erroneous and that the results of their holdings were unconstitutional.15 It appears those commentators would also view Pennsylvania's statute as unconstitutional.

3. States Taxing the Income of Trusts Based on the Residence of the Trustees or Beneficiaries

Some states, such as California and Mississippi, define resident trusts according to the residence of the trustees or beneficiaries, rather than that of the grantor. California imposes state income tax on the entire income of a trust if the trustees or noncontingent beneficiaries are residents of California, without reference to the residence of the settlor.16 The tax is apportioned according to the number of trustees who reside in the state.17 Similarly, the residence of the trustees determines whether a trust will incur income tax under Mississippi law.18

C. Tax Planning Strategies Using Delaware Trusts

There are several strategies involving Delaware trusts which may be useful in minimizing state income taxes applicable to trusts. The utility of the strategies described below will differ depending on which type of taxation system a grantor's home state has adopted, and the vigor with which the state taxing authorities administer and enforce the tax statutes. The strategies involve issues of local law and their viability should be considered by counsel in those jurisdictions.

1. How a Delaware Trust May Help Grantors Avoid Income Taxation by States Requiring a Significant Ongoing Connection with the State

Establishing a Delaware non-grantor resident trust, or moving an existing trust to Delaware, can provide significant state income tax advantages for settlors in states such as New York, New Jersey, Missouri, Michigan and Massachusetts, which require a trust to have a significant ongoing connection with the state in order to subject the trust to tax. For example, through careful drafting, it is possible for a New York resident settlor to create a Delaware trust in which he or she retains an interest and which is a non-grantor trust for income tax purposes, but the transfers to which are not treated as completed gifts.19 If all of the trust's income is either set

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13 Based on the courts' reasoning in *Gavin* and *Chase Manhattan*, it appears that it may be possible for a trust to avoid Connecticut or District of Columbia income tax if the trustee obtains an order from the appropriate court in Connecticut or the District of Columbia ceding all jurisdiction over the trust to Delaware.


17 *Cal. Rev. & Tax. Code §17743*. The U.S. Supreme Court has upheld states' proportional taxation of a trust based on the residence of a trustee. *See Greenough v. Tax Assessors*, 331 U.S. 486, 498 (1947) ("[T]he resident trustee was the possessor of an interest in the intangible [property], sufficient . . . to support a proportional tax . . . by Rhode Island.").

18 *See Fogel*, at 179 & n. 70 (analogyizing California's and Mississippi's taxation of trusts).


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Delaware Advantage, continued

aside for nonresident beneficiaries or distributed, the trust will not be subject to Delaware state income tax and New York will not impose a tax, despite its creation by a settlor residing in New York, as long as it satisfies the requirements of New York’s safe harbor. Additionally, the beneficiaries and trustee(s) of an existing New York trust might reduce or eliminate all state income tax imposed on the trust by eliminating the New York trustee and replacing it with a Delaware trustee, thus moving the trust from New York to Delaware, if none of the beneficiaries reside in New York and the trust otherwise satisfies the New York tax regulations.

2. Suggested Strategies for Using a Delaware Trust to Avoid Income Taxation by States Taxing Trusts Based on a Minimal Nexus with the State

a. Limited Power of Appointment

One strategy in states such as Pennsylvania may be to create a trust in which a nonresident of Pennsylvania has a limited power to appoint all or a portion of the trust assets in favor of a new trust. Upon exercise of such powers, the terms of the new trust may be substantially the same as the original trust. Arguably, the appointment of the trust assets to a new Delaware resident trust by the nonresident Pennsylvania powerholder would not constitute a transfer by a Pennsylvania resident, and therefore the new trust would not be a resident trust under Pennsylvania law. It seems that if the powerholder can appoint the assets in favor of anyone he or she chooses, either outright or in trust, it is possible that the resulting Delaware trust would not fall within the definition of a Pennsylvania resident trust. The trustee of the original trust would identify the resident Pennsylvania trust’s income tax return in the year of the appointment as the final return, and the new Delaware resident trust would no longer report Pennsylvania taxable income.

b. Distribution in Further Trust

Alternatively, the trustee might exercise a discretionary power to distribute all of the trust assets to a new Delaware resident trust for the benefit of the beneficiaries of the original trust upon substantially the same terms and conditions as the original trust. The trustee’s exercise of such a power could be characterized as a distribution of all of the trust assets which results in the termination of the original trust. Following distribution of all of the original trust’s assets, the trustee would identify the trust’s Pennsylvania tax return as the final return in the year of the distribution, and the new Delaware trust would no longer report Pennsylvania taxable income.

c. Trapping Trust

A final strategy may be to create a companion Delaware resident trust to which an annual distribution of all of the undistributed income of the Pennsylvania resident trust could be made. Under this strategy only the income would be distributed to a new trust, and the original trust would continue to exist as a Pennsylvania resident trust. The original trust will distribute all of its income annually and, consequently, will not have any Pennsylvania taxable income. The second trust, called a “trapping trust”, would be a Pennsylvania nonresident trust and would trap and eliminate state income tax. This strategy might also minimize or eliminate state income tax on trust net income that is actually distributed to beneficiaries by making the distributions to the trapping trust and delaying the distributions to beneficiaries from the trapping trust until a year when the trapping trust has little or no distributable net income.

For example, the trustee of a Pennsylvania resident trust could make a distribution of all of the undistributed trust income to a Delaware resident trust held for the benefit of the same individual beneficiaries. Amounts distributed by the first trust to the trapping trust would enter the trapping trust in a year in which the trapping trust makes no distributions to the beneficiaries and would be accumulated and added to principal. The income of the first trust would be carried out as a deduction for distributed income when it is distributed to the trapping trust; consequently, the Pennsylvania resident trust would have no income subject to the Pennsylvania income tax. The income or capital gains accumulated in the trapping trust would not be subject to Delaware income tax if none of the beneficiaries resides in Delaware and may not be subject to Pennsylvania income tax on income from non-Pennsylvania sources, because it would be created by the Delaware

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The Family Investment Partnership: Complexities Abound

By BRETT D. SOVINE
BROWN BROTHERS HARRIMAN TRUST COMPANY, LLC

Many articles have been written recently regarding family investment partnerships. Some proponents of the family investment partnership contend such an entity can solve all of a family’s investment concerns. In theory, the family investment partnership makes a lot of sense. A large extended family with substantial net worth consolidates its investable assets in a single family partnership. The partnership then hires one or more investment managers to manage the family’s consolidated portfolio. The structure offers many advantages, primarily of which are centralized investment management and increased pricing leverage for the members of the family. However, the family investment partnership, while simple in concept, can be anything but simple in operation. Complexities abound both from a tax standpoint and from a risk management perspective. That is to say nothing of the issues an investment family partnership can present from a family planning aspect.

An Illustration of the Family Investment Partnership

The issues involved in creating and maintaining a family investment partnership can be best illustrated with a simple example. Assume your firm has represented a family client for years. Your firm’s client was initially the matriarch and patriarch of the family, both of whom have died during your involvement in the representation of the family. The matriarch and patriarch died leaving six children who vary in ages from their mid-forties to late-fifties. All but one of the six children have children of their own and two of the children also have grandchildren. On a combined basis, the family investment portfolio totals $65 million. This article will address just some of the many issues that you, as the family’s advisor, will need to consider and work through, should your clients desire to create a family investment partnership.

Delaware Advantage, continued

trustee or some third person who does not reside in Pennsylvania.

D. Conclusion

This article has provided a necessarily brief sketch of states’ various approaches to income taxation of trusts. As summarily explained, Delaware law may allow tax planners to employ a number of strategies involving Delaware trusts to reduce or eliminate the state income tax liability of trusts.

Family Planning Issues

It would be neat and clean conceptually if each of your client’s children retained an equal amount of their respective inheritances from their parents’ aggregate estate, but that is rarely the case. Annual gifting disparities, estate planning at the children’s generation, spending habits and lifestyle choices likely will have resulted in wide disparities in investable assets of each child. Each child has investable assets to contribute to the family investment partnership, but the disparity in value owned by each child in relation to his or her siblings will result in disproportionate limited partnership interests for each child if the family members contribute all the family’s wealth to the partnership.

Disproportionate partnership interests may not pose a problem from a tax standpoint but could very well create issues in the family dynamic among the siblings. These issues are likely to be magnified by the limitations usually placed on the ability of a limited partner to withdraw from a limited partnership. From a gift and estate tax planning standpoint, the restrictions on transferability of limited partnership interests and the prohibitions against withdrawal of a limited partner are desirous, in that they form the foundation upon which most valuation discounts are derived. Furthermore, limiting withdrawal rights simplifies partnership accounting.

A family that is considering a family investment partnership should be counseled on the possibility of contributing some, but not all, of the family’s investable assets to the partnership. This may make it possible for each sibling to

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Family Investment Partnership, continued

have an equal percentage ownership in the family investment partnership, which, as will be discussed below, can also yield significant portfolio flexibility and tax savings.

Investment Management Issues

A primary advantage of the family investment partnership is that it results in a pool of investable assets that is substantially larger than its individual components. Aggregated purchasing power will usually result in the ability to negotiate a discounted fee for investment management services. It may also provide members of the family access to investment managers who have high minimum account size requirements. However, it introduces complexities into the investment process. Each of the siblings will have different investment needs. Because of the difference in their ages and potential variations in spending habits, the planning objectives and time horizon for each sibling are different. Some of the older siblings will be approaching retirement age, while the younger ones likely have between 15 and 20 years to retirement, resulting in very different investment risk tolerance profiles. The needs and goals of a family member who does not have children are drastically different than siblings with children and grandchildren. As discussed in greater detail below, the partnership income tax rules make it very difficult to account for varying risk tolerances and other investment objectives within a family investment partnership.

Tax Planning Issues

Managing a Tax Efficient Investment Portfolio

The partnership income taxation rules do not lend themselves to flexibility in the context of investment partnerships. Ideally, all the assets contributed to the family investment partnership would be contributed in the form of cash. It is much more likely, however, that each partner will contribute a portfolio of appreciated and depreciated investments to the partnership. The investment manager hired by the general partners of the partnership will decide which investments should be sold and which should be retained. Ideally, these decisions should be made purely from an investment standpoint, based on the investment goals of the portfolio. This will be difficult to do because, as mentioned previously, the family investment partnership makes it difficult for the investment manager to consider the risk tolerance of each of the partners in deciding which assets to sell and which to retain.

Managing income tax consequences can be a difficult task in a family investment partnership. Under the Code, the partnership structure is ignored with respect to built-in gains or losses realized on the sale of partnership property within the partnership’s first seven years (“pre-contribution gains or losses”).

The partnership tax attribution rules prohibit managing the family investment partnership in any tax-efficient manner for each partner as might be possible if there were six single family accounts. In essence, the investment decisions made to meet the needs of the family can take precedence over the tax

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1 These rules apply to any gains or losses triggered by assets that are sold within seven years of being contributed to the partnership. For purposes of this article, it is assumed all the assets of the family limited partnership are contributed to the partnership on the day it is created.

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Family Investment Partnership, continued

costs to the individual partners if care is not exercised in managing the family investment partnership with the tax picture of each partner in mind. Even with the issue of attribution in mind, managing the portfolio in a tax-efficient manner can be difficult if the family investment partnership is to be truly diversified into equities, debt, treasury inflation-indexed securities and alternative investments. The greater the number of contributed investments that must be sold following formation of the family investment partnership, the more difficult it will be to limit the income tax consequences to the individual partners of the partnership.

Unintended Taxation-Triggering Events

Unintended events can also trigger adverse tax consequences in a family investment partnership. An unexpected substantial cash flow need of one of the family partners can make it difficult to avoid an unintended tax consequence to the other partners if the need for cash arises within seven years of the formation of the partnership. Any forced sales to raise cash for one partner increase the likelihood of adverse income tax consequences to the partners that are not in need of the liquidity. Another often overlooked tax result is that, under the pre-contribution gain recognition rules of Code §704(c), it is possible for capital gains to be triggered at the partnership level on a sale of securities in an amount that exceeds the proceeds of the stock sale, depending upon which sibling contributed the stock that is sold. In this situations, it often makes more sense for the partnership to redeem part or all of a partner’s interest in the partnership so that the sibling in need of cash incurs the tax costs of the gain triggered by the recognition event. If the partner’s need for cash does not require the complete redemption of the partner’s interest in the partnership, the advisor must consider the impact of Code §731(a) on a partial liquidating distribution to the partner in need of cash. If the family investment partnership does not qualify as an investment partnership pursuant to Code §731(c)(3)(C)(i), the distributed securities could be taxed as a distribution of cash to the distributee partner, triggering unintended tax consequences. Often a loan from the partnership to the partner in need of liquidity is preferable from a tax standpoint in this situation.

The death of one or more of the partners can likewise create many issues for the family investment partnership. First, the death of a partner could create a liquidity need if the deceased partner’s estate needs funds for payment of death taxes. Second, the decedent partner’s personal representative will want to consider whether to make a Code §754 election to step up the basis of the decedent’s interest in the partnership’s assets for income tax purposes. An election under Code §754 cannot be made without the unanimous consent of all the partners of the partnership. Once made, the election is irrevocable. The election causes an adjustment to the income tax basis of any partner’s partnership interest where the partner dies after the election is made. This is the case even if market declines have reduced the fair market value of the partnership’s assets to the point where the automatic adjustment triggered under Code §754 would cause an undesirable step-down in the basis of the partnership interest of a subsequent partner to die. Great care should be given to the making of a Code §754 election under these circumstances, as it may have negative future implications on family harmony.

What To Do?

Single Investment Manager

While the obstacles created by the partnership tax rules are not insignificant, the family investment partnership can be a valuable component of a family’s overall planning if care is taken in establishing and administering the family investment partnership. You should consider advising your family client to limit the funding of the family investment partnership to a portion of the family’s total investable assets. For example, assume each of the siblings of your family client contributes only sixty percent of his or her family’s investable assets to the family partnership and retains forty percent to be managed as a separate, individual account. This would allow the investment manager to make adjustments in the retained individual portfolios to account for variances in risk tolerance. It would also provide the portfolio manager the ability to manage any unexpected tax consequences at the family partnership level by offsetting activity in each family member’s personal accounts.

Multiple Investment Managers

Many firms and commentators are now touting the advantages of an open architecture approach to

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Family Investment Partnership, continued

investment management. The idea is the family investment partnership could benefit if it could employ a “best in breed” approach to investment management. For example, after significant research, your family client in this example hires an investment management firm to take custody of (physical control over) all the family’s investments and asks the firm to analyze the family partnership’s investment portfolio and make strategic asset allocation decisions among different asset classes. The family chooses to hire the same firm to manage the core equity and municipal bond portions of the family’s portfolio. The family also asks the firm to analyze and recommend outside investment management firms that specialize in managing additional asset classes needed to meet the needs of the asset allocation model (e.g., international equities, high yield bonds, corporate bonds, and alternative investments) developed by the firm for each member of the family.

The family would like to hire the best manager in each of these asset classes to manage the family’s investment portfolio. This intuitively makes sense from an investment standpoint and is a service that many large investment management firms offer their large family clients. However, this type of engagement underscores the need for a retained investment portfolio for each partner of the family partnership. As additional investment managers are introduced to the investment management process, each manager will invariably insist on absolute discretion over trading decisions in its portion of the portfolio. Because each manager is focused solely on its portion of the family’s portfolio, it becomes much more difficult to manage (or even predict for that matter) the tax-efficiency of each individual partner’s share of the family’s portfolio. The risks and difficulties posed by a sudden cash need of one of the partners will be dramatically increased by the additional investment managers. One way to minimize the potential problems of this type arrangement is to structure the family’s affairs to make it unlikely that the assets of the partnership will have to be tapped to meet the needs of any of the partners in the first seven years of the relationship. In a similar way to the approach described above where the family has a single investment manager, this will usually involve advising each sibling to retain an individually managed investment account. Through each sibling’s personal investment account, the primary investment manager can better manage each partner’s taxes, investment risk and cash flow with reduced concern for the vagaries and sometimes counter-intuitive results of the partnership income tax rules.

Conclusion

There are many interrelated issues one must consider in advising a family client on incorporating a family investment partnership into their overall planning. It will be to everyone’s benefit if you give as much advance thought to the interaction between the family members and the family partnership as you can and structure the family investment partnership in a manner that preserves as much flexibility as possible. By balancing the partnership tax rules, the cash flow needs and investment risk tolerance disparities of each of the family members on the front end, you will put yourself and your client in a position to maximize the benefit of your client’s family investment partnership.

March 2, 2004
Before (Or After) You Say “I Do”—Marital and Cohabitation Agreements, A Guide for Estate and Family Law Practitioners

Faculty: Lise A. Fisher, Esq.
Albert Momjian, Esq.
Carolyn S. Nachmias, Esq.

Location: TBD (PBI/PBEC is being renovated and course may be held at a different location).

Time: 11:45 am--Registration and lunch
12:30 pm - 2:30-- Program

June 1, 2004
Business Succession Planning (working title).

Faculty: Nancy Drosdow, Principal, Center for Applied Research
G. Bradley Rainer, Esq.
Laura E. Stegossi, Esq.

This course will include one hour of ethics CLE credit.
Philadelphia Orphans’ Court Practice Update

By MARY JANE BARRETT
HARKINS AND HARKINS

In many ways the Orphans’ Court practitioner’s life has gotten easier in recent years. A number of important changes have taken place which are not reflected in the rules. Many essential forms and practice aids are posted and revised on the web long before printed manuals and rules books catch up, so desktop internet access is a necessity for the Orphans’ Court lawyer.

1. Cover sheets. Cover sheets have replaced backers in Philadelphia. Blue backers with volumes of typed information are now obsolete. (Don’t throw them away, though, since other counties still require them.) The initiation of the case management system brought a standard cover sheet with fill-in forms available on the court’s web-site: http://courts.phila.gov/. Each pleading is assigned a control number for tracking.

2. Stamped, addressed envelopes. Stamped, addressed envelopes are required with each Philadelphia Orphans’ Court filing, unless a Citation has been requested or the filing does not require notice, such as an Inventory or Annual Guardian’s report.

3. Rules. Integrated Pennsylvania and Philadelphia Orphans’ Court rules are now posted on the court’s website as well, and can be found by following links to “Local Rules” or going directly to http://courts.phila.gov/publications.html#rules.

4. On-line docket access. Docket access is also available on the Philadelphia court’s website, which can be searched by court term and number or by estate name search. The docket report provides an easy way to track a matter, identify the judge to whom it is assigned, and learn whether other parties have entered an appearance or filed pleadings. Though unofficial, and not a substitute for certified docket entries, internet docket access is a valuable tool.

5. On-line forms. Numerous pre-printed forms formerly distributed by the Clerk’s office, such as Guardian’s Inventory, Notice of Claim, and the Checklists for filing Accounts, are now downloadable from the “Forms” link of the Philadelphia court’s website at http://courts.phila.gov/forms.html. Petitions for Adjudication for estates, trusts, incapacitated persons’ estates and estates of principals under a power of attorney, and cover sheets are formatted for “write-on” on-line usage. Others must be printed and typed-on as usual at this time, but conversion of all forms to “write-on” is planned. Typewriters are not yet obsolete, but will be soon.

6. General Orphans’ Court information. In addition to the standard forms appearing under the “Forms” heading on the court website, additional useful information is posted under the main page of the Orphans’ Court Division at http://courts.phila.gov/common-pleas/orphans. The names of the judges and telephone and fax numbers are listed. In addition, a practice outline and forms for plenary and emergency guardians appear for “informational” purposes. Other areas of interest include links to the history of the Orphans’ Court, a staff directory for the Clerk of Orphans’ Court office, marriage license information, list of approved corporate fiduciaries and the procedure for qualification as an approved corporate fiduciary.

7. Written depositions for incapacity proceedings. Routine guardianship proceedings for alleged incapacitated persons are now easier and less costly with the authorized use of written interrogatories for medical testimony, since they eliminate the problem of finding a physician willing to come into court and the cost of the live testimony. Forms of written interrogatory-style deposition appear at both the “Forms” link of the the Philadelphia court’s website and the Orphans’ Court main page. Nevertheless, live medical testimony will generally be needed for contested or emergency guardianship matters.

8. On-line probate petitions. The Register of Wills of Chester County (http://www.chesco.org/wills/forms.html) has shown leadership in the area of probate practice and has posted its probate petitions on its website and formatted them to be filled in on line.

Practice Update, continued

Philadelphia, and the revised Green Book, Forms for Use Before the Orphans’ Court of Philadelphia, as the Philadelphia Estate Practitioner Handbook (PEPH) was a remarkable recent feat of the Probate and Trust Law Section. Not only did the book’s sponsor, Wachovia Wealth Management, publish the book in 3-ring binder format, and distribute it to all Section members earlier this year, it sponsored the PEPH website where all 484 pages can be viewed, searched and printed. The book has also been distributed to the Orphans’ Court judges state-wide and is seen as a prototype for a possible Pennsylvania Estate Practitioner Handbook. The website, which records in excess of 20,000 hits per month, is found at www.peph.com. Eventually, the forms may be converted to “write-on” forms as well.

10. Service of Citations. Some questions concerning the manner of service of citations have been clarified sua sponte by the Philadelphia Orphans’ Court. Recently, a preliminary decree awarding a citation in a matter other than a guardianship contained the following additional language:

“Pursuant to Section 765 of the Probate, Estates and Fiduciaries Code, the citation shall be served in the same manner as Original Process may be served in a civil action under Pa.R.C.P. 400, 400.1 and 402. Proof of service of the citation shall be made in the manner prescribed in Phila. O.C. Div. Rule 3.5.B.(1) and filed with the Clerk in the manner prescribed by Phila. O.C. Div. Rule 3.5.B.(2).”

Although Phila. O.C. Rule 3.5.B.(1) states that proof of service shall be by return of the sheriff, or by affidavit of the person mailing, publishing, or personally serving the citation, or by written acceptance of service by the person or on behalf of the person to whom the citation is directed, there is no mention of service by mail or publication in Section 765 of the PEF Code or in the civil rules. Thus, authorized forms of service under Section 765 and the civil rules are by sheriff, by a competent adult, or in another county by deputized service or by a competent adult forwarding the process to the sheriff of the county where service may be made.

Not addressed specifically in the preliminary decree is the apparent inconsistency in civil and orphans’ court rules regarding the time frame in which an answer to a citation may be filed, or, in other words, the number of days prior to the citation’s return date in which personal service must be made. Section 764 of the PEF Code states that a citation must direct that the respondent provide a complete answer to the citation not less than 10 days after service; however, civil rules mandate 20 days’ notice, as does Chapter 55 of the PEF Code addressing citations for incapacity proceedings. Good practice is to serve the citation a minimum of 20 days’ before the return date, and if service cannot be effected timely, to request an alias citation with an extended return date.

11. Probate and Trust Law Section Newsletters. The Section Newsletters for 2002 and 2003 have been posted on the Section’s area of the Philadelphia Bar Association website, http://www.philadelphiabar.org. The newsletters contain a wealth of information about procedural and substantive issues affecting estates lawyers. The Publications Committee is in the process of indexing the

newsletters for the past 10 years. Both the index and the past issues on the website will be posted for ready research access in the upcoming year.

12. Credit cards. VISA/Mastercard is now accepted in the Office of the Register of Wills and Clerk of the Orphans’ Court in Philadelphia for charges of $25 or more. The ability to compute a trust account filing fee and issue a check for the precise amount is no longer needed if plastic is used.

13. Coming soon. On the horizon for the first quarter of 2004 is the revised Practice and Procedure in the Philadelphia Orphans’ Court (known as the Red Book), the final part of the PEPH trilogy. Further practice changes lie ahead as the Court explores the introduction of electronic filing.
ETHICS COLUMN

By PAUL C. HEINTZ

Question: Do the Rules of Professional Conduct permit an estate planning attorney to sell life insurance, securities, or other financial products to his or client as part of the estate planning process?

The thought that an estate planning attorney might offer to sell an array of life insurance products, mutual funds, and other financial planning services in the course of the consultation and drafting process is alien to the traditional practitioner. Because this question has been raised in a number of ethics courses and has recently been submitted to the Philadelphia Bar Association's Professional Guidance Committee for a formal opinion, however, it appears some attorneys licensed to sell life insurance, securities and other products see nothing wrong with the idea. While the Rules do not prohibit an attorney from being a product salesperson when rendering estate planning advice, they make it difficult to do so.

The significant likelihood that an attorney-salesman will compromise both the attorney's loyalty to the client and his or her ability to exercise judgment objectively and exclusively for the benefit of the client is obvious. The client has sought out the estate planning attorney and has reposed his or her faith and trust in that attorney. The client fully expects the attorney to recommend a plan in the client's best interest. The estate planning attorney is expected to both recommend the appropriate members of an estate planning team and to judge objectively the services and products the team members recommend to the client. The client usually does not expect to contend with the attorney in a salesperson's role with all that that implies. Furthermore, if the attorney assumes the role of salesperson in the estate planning process, the attorney is likely to breach the trust the client has reposed in the attorney and is also likely to be in a position where he or she can neither objectively analyze the product and services nor assure the client that those recommended are actually needed by the client, are the best available and are offered at the least expense.

Pennsylvania is one of the few jurisdictions that has adopted a Rule that sets forth the responsibilities of attorneys who provide non-legal services. However, the Rule, Rule 5.7, does not provide a safe harbor for the prospective estate planning attorney-salesperson. Indeed, the Rule states that, where non-legal services are offered to the client as an integral part of the attorney's providing legal services, the standards are even tougher. Rule 5.7(a) makes it clear that attorneys who combine such services are subject to the Rules of Professional Conduct with respect to both legal and non-legal services.

The Rules of Professional Conduct invariably implicated in these situations are Rules 1.7(b), 1.8(a) and 1.8(f). Rule 1.7(b) makes clear that the attorney's loyalty to the client cannot become impaired by the attorney's other interests and that the attorney may not allow related business interests to affect the representation. It would seem that an attorney is prohibited by Rule 1.7(b) from recommending to a client a product the attorney knows is unneeded by the client or more expensive than comparable products or that would result in compensation to the attorney that is not otherwise warranted. In fact, Rule 1.7(b) seems to set a very challenging standard for an attorney-salesperson.

Rule 1.8(a) poses yet another challenge for the estate planning attorney wishing to don a salesperson's hat in the course of providing estate planning services. That Rule prohibits an attorney from entering into any business transaction with a client or knowingly acquiring a pecuniary interest adverse to the client unless the attorney takes three specific steps: (1) the attorney must disclose the transaction and its terms in writing to the client in a manner that can be reasonably understood by the client. Of course, full disclosure would require a statement about how the attorney will be compensated in the course of selling the product; (2) the attorney must give the client a reasonable opportunity to seek the advice of
Ethics Column, continued

independent counsel to review the transaction; and (3) the attorney must obtain the client’s written consent.

Rule 1.8(f) governs transactions wherein the attorney receives a commission when selling products and services to the client. It requires (1) obtaining the client’s consent after full disclosure; (2) assurance that there is no interference with the lawyer’s independence of professional judgment or with the client-lawyer relationship; and (3) that the attorney abide by the confidentiality rule, Rule 1.6.

The Rules do permit an attorney to sell life insurance, securities and other financial products without being subject to the Rules of Professional Conduct. However, this is only when the sales are to non-clients or when the sales to clients are clearly distinct from the legal services the attorney is providing to the client and when the client cannot reasonably believe that he or she is under the protection of the client-attorney relationship when offered such non-legal services by the attorney. Opinion 2003-16, recently issued by the Philadelphia Bar Association’s Professional Guidance Committee, provides helpful information for attorneys interested in providing non-legal services.

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

Send your questions and ideas to:

Paul C. Heintz
Oberman, Rebmann, Maxwell & Hippel, LLP
1617 JFK Boulevard
One Penn Center
19th Floor
Philadelphia, PA 19103

NEWSLETTER ARTICLES

What would you like to see in future issues of the Probate and Trust Law Section Newsletter? The Publications Committee is looking for articles and ideas of interest to the probate bar. Please send any articles or ideas to:

Susan G. Collings
Drinker Biddle & Reath, LLP
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I. TREASURY REGULATIONS

Regulations Allow Deduction for Charitable Lead Interest Preceded by a Non-Charitable Lead Interest

The Service has issued final regulations allowing an income, estate, and gift tax deduction for a charitable lead unitrust or annuity interest created after a noncharitable interest in the same trust. Under prior regulations, if a guaranteed annuity or unitrust interest is payable for private and charitable purposes from a trust and the private interest is payable before the expiration of the charitable interest, the charitable guaranteed annuity or unitrust interest is deductible only if it began either before, or at the same time as, the private interest. The new regulations have eliminated this rule. See Sections 1.170A-6(c)(2)(i)(E), 1.170A-6(c)(2)(ii)(D), 20.2055-2(e)(2)(vi)(f), 20.2055-2(c)(2)(vii)(e), 25.2522(c)-3(c)(2)(vi)(f) and 25.2522-3(c)(2)(vii)(e).

New Regulations Apply Net Gift Treatment to Taxable Transfers of QTIP Interests

Regulation Sections 25.2207A-1(b) and 25.2519-1(c)(4), issued July 18, 2003 and applying to transfers on or after that date, clarify how the amount of the taxable gift by a spouse who assigns all or part of his or her interest in qualifying terminable interest property is reduced by the amount of gift tax on the transaction recoverable from the transferees, using the interrelated calculations applied in net gifts. The regulations also state that the spouse's failure to exercise the right under Section 2207A, to recover the gift tax on such transfers from the transferees is an additional gift of the unrecovered tax.

Final Regulations on Split-Dollar Life Insurance Generally Track Proposed Regulations

The Service has issued final regulations on the income, employment, and gift tax treatment of split-dollar life insurance arrangements. The final regulations, which generally follow the proposed regulations issued in July 2002 and May 2003, are designed to eliminate the tax advantages of equity split-dollar life insurance arrangements by taxing all economic benefits provided to the non-owner of the policy.

The final regulations provide that the tax treatment of split-dollar life insurance arrangements is determined under one of two sets of rules, depending on who owns the policy. If the employer owns the policy, then the premium payments are treated as providing taxable economic benefits to the employee. These benefits include the employee's interest in the current life insurance protection and policy cash value. (Reg. Section 1.61-22) If the employee owns the policy, the employer's premium payments are treated as loans to the employee. Unless the employee is required to pay the employer market-rate interest on the loan, he or she will be taxed on the difference between market-rate interest and the actual interest. (Reg. Section 1.7872-15)

The final regulations apply to any split-dollar life insurance arrangement entered into after Sept. 17, 2003 and to any split-dollar life insurance arrangement entered into on or before September 17, 2003 if the arrangement is "materially modified" after that date. (Reg. Section 1.61-22(j); Reg. Section 1.7872-15(n)) The final regulations provide a non-exclusive list of changes that will not result in a material modification for this purpose. The proposed regulations may be relied on for arrangements entered into on or before September 17, 2003.

The preamble to the final regulations states that an arrangement that is otherwise described in Notice 2002-8 (which included certain transition rules for split-dollar arrangements entered into before January 28, 2002, which rules expire on December 31, 2003) be treated as materially modified for purposes of the effective date provision if the change in the split-dollar arrangement is made solely to comply with these transition rules.

In conjunction with the issuance of the final regulations, the Service issued Revenue Ruling 2003-105 listing certain revenue rulings which are now obsolete with respect to split-dollar life insurance

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arrange-ments entered into, or materially modified, after September 17, 2003. However, for arrangements entered into on or before September 17, 2003, taxpayers may continue to rely on these revenue rulings to the extent described in Notice 2002-8, but only if the arrangement is not materially modified after September 17, 2003.

II. COURT DECISIONS

Seventh Circuit Affirms No Annual Gift Tax Exclusion Without Present Interest

In Hackl v. Commissioner, 92 AFTR 2d 2003-5254 (7th Cir. 2003), a couple gave their children and grandchildren units in a limited liability company. The couple reported the gifts as 2503(b) annual exclusion gifts on their 1995 and 1996 gift tax returns. The Service disallowed the 1996 exclusions.

In Estate of Engelman v. Commissioner, 121 TC No. 4, No. 4668-02 (2003), decedent and her husband established a living trust in California, where they resided. The trust provided that on the death of the first spouse to die, all assets were to be placed in Trust A. However, assets disclaimed by the surviving spouse were to be placed in Trust B. The surviving spouse had a power of appointment effective at death over Trust A.

Husband died in 1997 when the total value of the trust was about $1.5 million. In 1998, decedent executed a will in which she exercised her power of appointment over the Trust A corpus. She died one month later. A few months later the special administrator of decedent’s estate executed a disclaimer of her interest in Trust A assets valued at approximately $600,000 as of husband’s earlier death. Those assets were placed in Trust B and distributed to the beneficiaries thereof.

The Service argued that the disclaimer was not a qualified disclaimer under Section 2518 because the power of appointment exercised by decedent was an acceptance which became effective and irrevocable at her death. The estate maintained, based on state law (California), that the power of appointment never became effective because the disclaimer subsequently executed by the administrator related back to husband’s death and therefore had to be treated as predating the exercise of the power of appointment.

The Tax Court, examining California law, stated that decedent’s exercise of a power of appointment, which on its face provided for disposition of the assets of Trust A in their entirety, and her subsequent death without having amended the document’s language or in any way having restricted its reach, is reasonably interpreted as implying an intent to direct or control the property for the benefit of the parties named in the power of appointment. Therefore, the subsequent disclaimer would lack efficacy for State law purposes, and the relation-back doctrine would not apply. In addition, the Tax Court stated that regardless of the validity of decedent’s disclaimer under State statutes, the relation-back concept is entitled to only limited recognition for Federal tax purposes and there were no compelling reasons to apply the doctrine in this case. Therefore, the trust assets that were the subject of the disclaimer were includable in decedent’s gross estate.

III. IRS REVENUE RULINGS, REVENUE PROCEDURES AND NOTICES

Redemption to Pay Death Taxes Does Not Adversely Affect Estate’s Family Business Deduction

In Revenue Ruling 2003-61, 2003-24 IRB 1015, decedent owned shares of stock in a

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corporation with an adjusted value for purposes of Section 2057(d) of $3 million at the time of his death. The value of his adjusted gross estate under Section 2057(c) was $5 million. He had made no actual or deemed gifts of the stock during his life. The shares passed to his children under his Will. The estate made a QFOBI election which complied with Section 2057. To pay the federal and state estate taxes, the executor caused the corporation to redeem one-third of the stock in a distribution meeting the requirements of Section 303.

Under the QFOBI rules, the benefit of the deduction is subject to recapture if, within 10 years of the decedent’s death and before the qualified heir’s death, more than 50% of the value of the interest in the closely held business is distributed, sold, exchanged, or otherwise disposed of, or money and other property attributable to the interest is withdrawn from the trade or business. However, applying rules similar to the rule in Section 6166(g)(1)(B), a distribution in redemption of stock to which Section 303 applies is not a disposition that triggers an additional estate tax with respect to a QFOBI and the redemption does not affect the initial determination of whether the estate is eligible to make the QFOBI election.

The Service ruled that although following the redemption of one-third of the stock in a distribution that satisfied Section 303, the adjusted value of the QFOBI ($2 million) no longer exceeded 50% of decedent’s adjusted gross estate, the QFOBI election is not affected because the distribution in redemption does not affect the initial determination of whether decedent’s estate was eligible to make the QFOBI election. In addition, the Service concluded that the distribution in redemption was not a disposition of a portion of the QFOBI triggering a recapture tax.

IRS Updates and Expands Sample Charitable Remainder Annuity Trust Forms

The Service has issued a series of revenue procedures with updated sample trust instruments for certain types of charitable remainder annuity trusts (CRATs) and new samples for additional types of CRATs. Each sample is annotated, contains alternate sample provisions, and assumes a distribution of trust assets to a charitable remainderman following the annuity payments. The samples are provided in separate revenue procedures, as follows:


Rev Proc 2003-54, an inter vivos CRAT providing for annuity payments for a term of years.


Rev Proc 2003-56 ( superseding Rev Proc 90-32 , Sec. 5) contains samples for an inter vivos CRAT providing for annuity payments payable concurrently and consecutively for two measuring lives.

Rev Proc 2003-57 ( superseding Rev Proc 90-32 , Sec. 6), a testamentary CRAT providing for annuity payments for one measuring life.

Rev Proc 2003-58, a testamentary CRAT providing for annuity payments for a term of years.

Rev Proc 2003-59 ( superseding Rev Proc 90-32 , Sec. 7), a testamentary CRAT providing for annuity payments payable consecutively for two measuring lives.

Rev Proc 2003-60 ( superseding Rev Proc 90-32 , Sec. 8), a testamentary CRAT providing for annuity payments payable concurrently and consecutively for two measuring lives.

The Service will recognize a trust meeting all the requirements of a CRAT if (i) the trust instrument is substantially similar to the sample or integrates alternate provisions into a document that is substantially similar to the sample, and (ii) the trust operates consistently according to its terms and is valid under local law.

Guidance Issued Following Craft on Collection from Property Held in Tenancy by Entirety

In Notice 2003-60, following the decision in United States v. Craft, 535 U.S. 274 (2002), the Service has issued guidance on collection from property held in a tenancy by the entirety when only one spouse is liable for the outstanding taxes. In Craft, the

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Supreme Court held that a federal tax lien arising under Section 6321 on all property and rights to property of a delinquent taxpayer attaches to the rights of the taxpayer in property held as a tenancy by the entirety, even though state law (in this case Michigan) insulates the property from the claims of creditors of only one spouse.

The guidance states the general principles the Service will rely on when addressing issues raised by the decision: (i) Craft confirms that under Section 6321, the federal tax lien attaches to all the property and rights to property of the taxpayer; (ii) the Service will not apply Craft to interests created prior to the decision to the detriment of third parties who reasonably relied on the belief that state law prevents the attachment of a federal tax lien; and (iii) the IRS recognizes the practical problems inherent in seizure and sale of entireties property, and, therefore, will levy on more liquid assets where appropriate.

The Service will determine on a case-by-case basis when to use lien foreclosure for entireties property. The value of the liable spouse’s interest in the property will be deemed to be one-half. Finally, if the entireties property subject to the federal lien has been sold or transferred without a provision for discharge of the lien, this will encumber a one-half interest in property held by the transferee.

Service Acquiesces in Walton

In Notice 2003-72, the Service has announced that it will follow the Tax Court’s decision in Walton v. Commissioner, 115 T.C. 589 (2000), which held that example 5 of Reg.

Section 25.2702-3(e) is invalid. Example 5 of Reg. Section 25.2702-3(e) states that an individual's right to receive a unitrust amount for 10 years is a qualified unitrust interest to the extent of the right to receive the unitrust amount for 10 years or until the individual's death. The unitrust amount payable to the individual's estate if he or she dies during the 10-year period is not a qualified interest.

The Tax Court in Walton held that example 5 was an unreasonable interpretation and an invalid extension of Section 2702, and concluded that a retained annuity payable for a specified term of years to the grantor, or to the grantor’s estate if the grantor dies before the expiration of the term, is a qualified interest for the specified term.

Based on the Tax Court’s decision, the Service stated that if presented with facts similar to those in example 5, it would treat the retained unitrust payable to an individual or an individual’s estate as a qualified interest payable for a specified term. The Service also stated that the Regulations would be amended to conform to the Notice.

IV. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

Reformation of GRATS Not Effective for Gift Tax Purposes

In TAM 200319001, a husband and wife each created two GRATs, designating an independent trustee and funding the trusts with stock. The terms of each GRAT provided for the payment of an annuity to the grantor for a three-year period, with the remainder distributed to the grantor’s children. In the event a grantor died within the three year term, the annuity would be paid to the surviving spouse with the remainder distributed to a marital trust. If the spouse predeceased the grantor, or the grantor elected to revoke the spouse’s interest, the grantor was given a testamentary general power of appointment over the trust assets.

In reporting the value of each gift to the GRATs, the grantors calculated their respective retained interests as the present value of the annuities. The Service found that the revocable spousal interests were not qualified interests under section 2702, whereupon the trustee amended the GRATs to provide a retained annuity similar to that upheld in Walton v. Commissioner, 115 T.C. 589 (2000). The Service ruled under these facts that the retroactive reformation of the GRATs was not effective for gift tax purposes, noting that (i) the trustee’s authority under the GRAT agreements did not include the ability to completely change dispositive provisions to enhance tax benefits, and (ii) each of the grantor’s annuity interests was not the equivalent of a term of years annuity, which would qualify under Walton.

Charitable Trust Gains on Redemption of Contributed Stock Not Taxed to Donor

In PLR 200321010, a donor transferred stock that was subject to restrictive buy-sell agreements to a CRUT. The agreements provided that every time the CRUT trustee wanted to sell or dispose of the stock, the corporation would have the right to purchase the stock for the formula price under the agreements.

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Making a QTIP election for the value of the trust, including both Trusts B and C. As a result of a miscalculation, the value of the property in Trust B was reported incorrectly and the marital deduction claimed for Trust B was less than the amount that should have been claimed, resulting in estate tax liability. The trustee requested a ruling on the validity of the QTIP election for the value of the interest passing to Trust B.

On the basis of these facts, the Service ruled that (i) under Rev Proc 2001-38, the QTIP election with respect to Trust C would be treated as a nullity, and (ii) although the QTIP election for Trust B was valid and irrevocable, the miscalculation of the value of the property passing to Trust B did not preclude a marital deduction for the full value of the property used to fund Trust B, if the estate filed a supplemental estate tax return before the expiration of the statute of limitations correcting the description of the trust for which the QTIP election was made and reporting the full value of the property subject to the QTIP election.

Extension Granted To Make Alternate Valuation Election

In PLR 200324048, the executor for a decedent’s estate hired an accountant to prepare the estate tax return. The accountant requested an extension of time to file the return, and subsequently filed the return but failed to make the election to use alternate valuation under Section 2032. After the Service issued a closing letter accepting the return as filed an attorney, hired by the executor, later discovered the accountant’s failure upon a review of the return. The executor then filed a supplemental return making the Section 2032 alternate valuation election along with a request for an extension of time to make the election. Noting that the estate was eligible to use alternate valuation, the Service granted the extension pursuant to Reg. Sections 301.9100-1 and 301.9100-3, determining that (i) the estate acted reasonably and in good faith, and (ii) the interests of the government were not prejudiced.

Foundation Given Extension of Time To Dispose Of Excess Business Holdings

In PLR 200332020, a private foundation was the beneficiary of a significant amount of stock in a company that consisted of three fitness clubs and adjacent real estate holdings. The foundation sold two of the clubs and attempted unsuccessfully to sell the third club, despite diligent and continuous efforts to dispose of the third club. The foundation requested an extension of time in which to dispose of the third club under Section 4943(c)(7) (under which the five-year disposal period may be extended) in order to realize its true value. Based on the facts as presented, the Service concluded that the foundation satisfied the provisions of Section 4943(c)(7) and granted the requested extension to dispose of its excess business holdings.

Reformation of Discretionary Trust into CRUT Qualifies for Estate Tax Deduction

In PLR 200330028, a marital trust created by decedent’s predeceased spouse provided that after decedent’s death the trust income was to be paid 60% to a son and 40% to two granddaughters. Decedent’s revocable trust provided that the income was to be distributed

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to the son for life. On the son’s death, the residue of both trusts for his benefit were to be distributed to charity. A judicial reformation of son’s share of the marital trust and the revocable trust was initiated so that they would qualify as charitable remainder unitrusted under Code section 664(d)(2); the marital trust would be divided into two trusts, one for the son funded with 60% of the assets, which would be reformed, and one for the granddaughters. The son disclaimed any right to a principal distribution or income in excess of the unitrust amount.

On the basis of these facts, the Service concluded that the proposed reformation of the two trusts would be a qualified reformation under Section 2055(e)(3) and the estate would be entitled to an estate tax charitable deduction for the present value of the remainder interest in the two reformed trusts because (i) the son’s interest terminates on the same date both before and after the reformation, (ii) the reformation is effective as of the decedent’s death, (iii) the charitable interests would have qualified for an estate tax charitable deduction under Section 2055(a), but for Section 2055(e)(2), (iv) the actuarial value of the reformed charitable remainder interest would not differ by more than 5% of the actuarial value of the charitable remainder interest before reformation, and (v) a judicial proceeding was brought within 90 days of the date that the estate tax return was due.

Gift Tax Assignment Clause Void as Contrary to Public Policy

In TAM 200337012, a donor and his wife formed a partnership, in which the husband had a general and limited partnership interest. The donor assigned a fractional portion of his limited partnership interest to a trust, defined as that fraction of the partnership interest having a fair market value on the gift date of a set amount. The donor filed a gift tax return reporting the value of the gift as the set amount minus $5,000.

The Service, following Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), and Rev. Rul. 86-41, 1986-1 C.B. 300, concluded that the fractional share clause, which stated that if the Service determined that the value of the interest was greater than the set amount, the percentage interest in the partnership that exceeded the set amount value as determined for gift tax purposes would be retransferred to the donor, was void as contrary to public policy.

Exercise of Power of Adjustment Will Not Result in Gift Tax Consequences

In PLR 200334025, a trust created for the benefit of settlors’ son had five trustees, two of whom were settlors’ grandchildren (the presumptive remaindermen) and three individuals who were neither current beneficiaries nor presumptive remaindermen of the trust, although two of them had an indirect contingent interest in the trust. Applicable state law authorized a trustee, other than a current beneficiary or presumptive remainderman, to adjust between principal and income to the extent the trustees deemed advisable. The three individuals exercised the power of adjustment to transfer principal to the income account, with the income distributed to the son under the trust’s terms. The Service ruled on the basis of these facts that the exercise did not cause the remaindermen to be treated as having made a gift to the income beneficiary.
Report of the Chair, continued

thoughts – some mine, some offered by others – for next year’s Executive Committee to consider:

Should there be term limits for standing committee chairs? Even after giving more than their fair share in the form of many years of good service, some chairs might think they would be letting the Section down by “un-volunteering.” Having a pre-set term would let these people off the hook, and it might be healthy for the Section to give more members the opportunity to lead committees.

Is quorum reform needed? In an organization of busy volunteers, Executive Committee quorums are sometimes difficult to achieve. Moving the meetings from afternoons to mornings and gentle prodding from the Secretary and the Chair seemed to have helped this year. But, the risk of quorum-less Executive Committee Meetings remains, and it is inappropriate for the Executive Committee to spend or to speak for the Section without a quorum.

Does the Nominating Committee need more past Chairs? Having at least a majority of past Chairs would ensure that the Committee would have experience and valuable long-term perspective. And, including the Chair-Elect (or Vice Chair, see below) would provide some equally valuable “short-term” perspective.

Does the Section really need both a Chair-Elect and a Vice Chair? The duties of both offices (acting as Treasurer and planning the Annual Meeting) could easily be handled by one person. And, to be candid, some consider a four-year officer progression to become Chair to be a long haul, especially when many start that progression after serving several years as chair of a standing committee.

To keep this Report from becoming too long, I should stop there.

But, I could not end this, my last column, without thanking, on behalf of the Section, the Officers, the Executive Committee and, of course, the workhorses who serve and lead the standing committees and ad hoc committees. Thank you.

JOIN A COMMITTEE

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

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Name: ____________________________

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Committee Preferences:

First: ____________________________

Second: __________________________

Third: ____________________________

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