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newsletter

Wealth Management Update

2010 Year-End Review

Family Limited Partnerships and LLCs

Tax Court Finds Transfers of FLP Interests Do Not Qualify for the Gift Tax Annual Exclusion Because Gifts Were Not of Present Interests – *Price v. Commissioner*, TC Memo 2010-2

This Tax Court decision provides guidance on the availability of the annual exclusion from gift tax under Section 2503(b) for gifts of interests in family limited partnerships. It is an important case for anyone who plans to engage in this kind of gifting, and it calls for a careful review of the provisions of the partnership or LLC agreement.

In 1976, Walter Price started a company, Diesel Power Equipment Company ("DPEC"), which distributed and serviced heavy equipment. Some time later, Mr. Price made the decision to sell the business. In 1997, he formed Price Investments Limited Partnership as a limited partnership and contributed to it the stock in DPEC and three parcels of commercial real estate. When it was formed, the partnership was owned 1% by its general partner, Price Management Corp., 49.5% by the Walter Price Revocable Trust and 49.5% by Mr. Price's wife's revocable trust. Price Management Corp. was owned by Mr. and Mrs. Price's revocable trusts.

In 1998, the partnership sold the DPEC stock and invested the proceeds in marketable securities. Over the next several years, each of Mr. and Mrs. Price gifted interests in the partnership to their children such that by 2002 the children's cumulative interest in the partnership was 99%. Gift tax returns were filed properly for each year, reporting zero gift tax because of the use of annual exclusion and unified credit amounts. Valuation reports were attached to the gift tax returns indicating substantial discounts for lack of control and marketability (which the IRS stipulated were reported correctly).

The IRS issued the Prices deficiency notices disallowing the use of the gift tax annual exclusion under Section 2503(b) with respect to the transferred partnership interests on the ground that the gifts were of "future interests in property." The Prices argued that their gifts were of present interests because (i) the donees could freely transfer the interests to one another or to the general partner and (ii) each donee had immediate rights to partnership income and could freely assign income rights to third persons. Relying on *Hackl*, the IRS argued that the transferred partnership interests were future interests because the partnership agreement effectively barred transfers to third parties and did not require income distributions to the limited partners.

The Tax Court agreed with the IRS and applied the methodology of *Hackl* in concluding that the Prices failed to show that their gifts conferred upon the donees the immediate use, possession or enjoyment of either (i) the transferred property or (ii) the income therefrom.

In its analysis of the "transferred property" prong, the court focused on the terms of the partnership agreement. Specifically, the court notes that the donees have no unilateral right to withdraw their capital accounts; that their rights to transfer and assign partnership interests are restricted; and that a transferee is a mere assignee rather than a substitute limited partner. The Tax Court, citing *Hackl*, states that transfers subject to the contingency of approval cannot support a present interest characterization.

In its analysis of whether the gifts of the partnership interests afforded the donees the immediate use, possession or enjoyment of "the income therefrom," the court held that (1) the partnership would have needed to generate income at or near the time of the gifts;

(2) some portion of that income would have to have flowed steadily to the donees; and (3) the portion of income flowing to the donees had to be readily ascertainable. The Court found that the partnership's income did not flow steadily to the donees since there were no distributions in certain years. Furthermore, the court found problematic the fact that neither the partnership nor the general partner had any obligation to distribute profits, and distributions were secondary to the primary purpose of the partnership in achieving a reasonable, compounded rate of return on a long-term basis.

Tax Court Holds Loan from FLP to Surviving Spouse's Estate Not "Necessarily Incurred" and Interest thereon Not a Deductible Administration Expense; Transfer to FLP Escapes Estate Inclusion under Consideration Exception – *Estate of Black v. Commissioner*, 113 T.C. 15 (2009)

In this case, the Tax Court objected to a *Graegin*-type loan arrangement between related entities. It is an important decision to review if you are considering such a loan. This case also considered whether certain transfers of FLP interests are includible in a decedent's estate.

Estate of Black involves the estates of Samuel and Irene Black. Samuel Black owned a large amount of stock in Erie Indemnity Company. In 1993, at the age of 91, Mr. Black, his son and two trusts for Mr. Black's grandchildren contributed their Erie stock to an FLP in exchange for partnership interests proportionate to the fair market value of the Erie stock each contributed. The transaction was initiated to implement Mr. Black's buy-and-hold philosophy with respect to the family's Erie stock, and concerns about his son's marriage and the possibility that his grandsons would sell the stock when their trusts terminated. At the time the FLP was formed, Mr. Black was in good health and retained approximately $4 million in assets outside the FLP.

Mr. and Mrs. Black died within five months of each other, with Mr. Black dying first. There was a liquidity shortfall to pay estate taxes, so the Executor (who was their son) approached several banks about a loan but he did not like the terms, and the banks did not want FLP interests as collateral. The Executor also approached the Erie Company about a loan, but was turned down. Ultimately, the Blacks' son, as general partner of the FLP, undertook a secondary offering of approximately one-third of the FLP's Erie stock. The FLP and Mrs. Black's estate worked out a loan whereby the FLP would lend the estate approximately $71 million to pay, among other things, estate taxes, a charitable legacy and certain expenses in connection with the secondary offering. The interest was payable in a lump sum on a date more than four years from the date of the loan, and the estate had no right to prepay interest or principal, being patterned on the loan approved in the *Graegin* case.

The Executor computed the interest on the loan to be $20,296,274 and deducted that amount on Mrs. Black's estate tax return, in full, as an administration expense of her estate. The IRS assessed large estate tax deficiencies in both estates, denying the deductibility of the interest paid, and arguing for the inclusion in Mr. Black's estate, under Section 2036, of the Erie stock Mr. Black transferred to the FLP.

The taxpayer won on the 2036 issue, with the Tax Court finding that there was a substantial non-tax reason for forming the FLP and that Mr. Black's transfer of the stock to the FLP in exchange for the partnership interest was a bona fide sale for adequate and full consideration in money or money's worth. With respect to the deductibility of the loan interest, the estate argued that the loan was bona fide and similar to the loan blessed by the Tax Court in the *Graegin* case. The Tax Court ruled for the IRS, holding that the loan was not “necessarily incurred” (and thus not a deductible administration expense) since the FLP could have distributed Erie company stock in redemption of the estate’s partnership interest in an amount that could have covered the estate tax, charitable legacy and other expenses. The Tax Court also was troubled by the fact that the Blacks’ son effectively stood on both sides of the loan transaction, as general partner of the FLP and as Executor of Mrs. Black’s estate.

Tax Court Finds Transfer of an Interest in a Limited Partnership and Timberland to an FLP Was Not Includible in the Decedent’s Gross Estate Under Section 2036(a) Because the Transfer Was a Bona Fide Sale For Adequate And Full Consideration – *Estate of Shurtz v. Commissioner*, TC Memo 2010-21 (February 3, 2010)

This Tax Court decision provides another Section 2036 victory for the taxpayer by holding that assets transferred to an FLP were not includible in the decedent’s gross estate under Section 2036(a) because the transfer was a bona fide sale for adequate and full consideration. This case is particularly taxpayer friendly because the Tax Court focused on the non-tax purposes for forming the FLP and was able to overcome several bad facts.

The Decedent, Mrs. Shurtz, died in California in 2002. She was survived by her husband and children. The Decedent and her siblings grew up in Mississippi where their family owned and operated a timberland business.

By 1993, many family members held separate interests in the business. On the advice of counsel, the family formed a limited partnership, Timberlands LP, to manage and operate the business. A corporation was formed which owned a 2% GP interest in Timberlands LP. The Decedent and her two siblings each owned one-third of the stock of the GP and the Decedent owned a 16% LP interest.

After Timberlands LP was formed, the Decedent and her siblings raised concerns about protecting the family business from “Jackpot Justice” in Mississippi. They were concerned that they could be sued and a judgment entered against them and they could lose control of the business. To avoid this problem, their attorney recommended that each family hold its Timberland LP interest in a separate limited partnership. This recommendation was followed so that the active timber business was held in Timberland LP and the equity ownership was held in several new FLPs, one of which the FLP created by the Decedent.

The Decedent also wanted to give her children and grandchildren interests in 750 acres of timberland that she acquired from her parents.

In 1996, The Decedent and her husband formed an FLP. The purposes of the FLP were (1) to reduce the estate (2) provide asset protection and (3) provide for heirs. The Decedent transferred a 6.6% interest in the 750 acres to her husband who in turn received a 1% GP interest in the FLP. The Decedent contributed the balance of her interest in the 750 acres and her 16% LP interest to the FLP for a 1% GP interest and a 98% LP interest in the FLP.

The FLP agreement had substantial restrictions designed to keep persons outside the family from acquiring interests in the FLP.

Between 1996-2000, the Decedent made 26 gifts of .4% LP interests to her children and grandchildren. When the Decedent died in 2002, she held a 1% GP interest and a 87.6% LP interest in the FLP.

The IRS contended that the value of the assets the Decedent contributed to the FLP were includible in the value of her gross estate under Section 2036.

The "bad facts" in this case included the following: (1) the FLP did not maintain books of account as specifically required in the partnership agreement; (2) the partnership bank account was not set up until almost four months after formation of the FLP, and after two months as a checking account, it was changed into a money market account; (3) the Decedent and her husband paid some of the FLP's expenses from their personal bank accounts, being reimbursed by the FLP for some payments and having others credited to their capital accounts; and (4) there were not always proportional distributions from the FLP to its partners.

The Tax Court reviewed the management style and operations of the LPs and the Judge noted that the entire family was conscientious about managing the family timber business, had a mission statement and held annual meetings in Mississippi.

The Tax Court found that transfer to the FLP was a bona fide sale because protecting the assets from potential litigants and using the FLP to facilitate the active management of the assets were legitimate and significant non-tax reasons for its creation. The Court acknowledged that reducing the estate tax was a motivating factor, but went on to say there were valid and significant non-tax reasons for establishing the partnership – therefore, the bona fide sale element was satisfied.

The Court found that the Decedent received an interest in the FLP that represented adequate and full consideration because (1) the participants in the FLP received interests proportionate to the value of the property each contributed; (2) the respective contributed assets were properly credited to the transferors' capital accounts; (3) distributions required negative adjustments to distributee capital accounts; and (4) there was a legitimate and non-tax reason for forming the FLP. Therefore, the FMV value of the Decedent's interest in the FLP, rather than the FMV of the assets she contributed to the FLP was includible in her estate.

Since the Tax Court found that a bona fide sale for adequate and full consideration occurred, the FMV of the property the Decedent contributed to the FLP was not includible in her gross estate under Section 2036.

Federal District Court Finds Transfer of Interests in LLC to Children Does Not Qualify for the Annual Gift Tax Exclusion – *Fisher v. Commissioner*, No. 1:08-CV-00908 (March 11, 2010)

A U.S. District Court in Indiana found the transfer of interests in a LLC to children did not qualify for the annual gift tax exclusion because the interests were considered "future" rather than "present" interests in property due to operating agreement restrictions on the children's rights relating to the property.

The Fisher parents transferred an LLC, in its entirety, to their 7 children over the course of 3 years using annual exclusion gifts. The LLC owned undeveloped land in Michigan. The Fishers presented three arguments in support of their claim that these were present interest gifts, all of which were rejected by the court. First, the children had the unrestricted right to receive distributions from the LLC. The court said since the timing and amount of any distributions were within the exclusive discretion of the Manager of the LLC, the right to such distributions was not a "substantial present economic benefit." Second, the children had the unrestricted right to use the land which was the primary asset of the LLC. The court said there was no indication that the right to use the land was transferred with the LLC interests, and, even if it was, "the right to possess, use, and enjoy property, without more, is not a right to a, "substantial present economic benefit." And third, the children had the unrestricted right to transfer their LLC interests. The court noted that the operating agreement contained a right of first refusal, allowing the LLC to match any offer and to pay with a promissory note of up to 15 years. Consequently, the court concluded that this effectively prevented the children from transferring their interests in exchange for immediate value.

This case sheds light on what sort of "use" constitutes present economic benefit (it appears a right to use the real property held by an entity does not) and how to treat a right of first refusal. A right of first refusal appears to be a sufficient transfer restriction to cause a partnership or LLC interest to fail the property test, but it is unclear what role the payment terms play.

8th Circuit Finds Limited Partnership's Transfer Restrictions Disregarded when Valuing Stock for Gift Tax Purposes – *Holman v. Commissioner*, 2010 WL 1331270 (April 7, 2010)

The 8th Circuit, in affirming the Tax Court, found that a limited partnership created by a couple to hold Dell stock in trust for their children could not claim that the partnership's transfer restrictions constituted a bona fide business arrangement. Therefore, under §2703, the restrictions could be disregarded when valuing the stock for gift tax purposes and applying smaller lack of marketability and minority interest discounts than claimed by the donors.

The Tax Court had held that the transfer restrictions were designed principally to discourage the children's dissipation of the wealth transferred to them by way of gift, and said restrictions did not constitute a bona fide business arrangement within the meaning of §2703(b)(1).

The Holmans argued that the Tax Court applied an overly restrictive definition of the phrase "business arrangement" and effectively imposed an "operating business nexus." In affirming the Tax Court decision, the 8th Circuit rejected the Holmans' claims and reasoned that "context" matters when analyzing whether a restriction constitutes a bona fide business arrangement; in this case, there was no "business," active or otherwise.

Gift Tax Cases and Guidance

Tax Court Holds that Gift Tax Paid with Respect to Decedent's Deemed Gifts of Remainder Interests in QTIP Property Are Includible in her Gross Estate under Section 2035(b) - *Estate of Morgens v. Commissioner*, 133 T.C. 17 (2009)

Anne Morgens and her husband established a revocable inter vivos trust in a community-property state. After Mr. Morgens' death, the portion of the trust representing his one-half of the community property was allocated to a residual trust for Mrs. Morgens, for which a QTIP election was made. During Mrs. Morgens' lifetime, the residual QTIP trust was divided into two trusts, and Mrs. Morgens made gifts of her qualifying income interests to both trusts, which, in turn, triggered deemed transfers of the remainder interests under

Section 2519. The Trustees of the QTIP trusts paid the gift taxes on these deemed transfers.

Mrs. Morgens died within three years of the transfers. Her Executor did not include the amounts of gift tax paid by the Trustees of the QTIP trusts on her estate tax return on the theory that those amounts were not gift tax paid by Mrs. Morgens within three years of her death. The IRS audited the return and determined an estate tax deficiency of approximately $4.6 million.

The IRS argued that the gift tax amounts were includible in Mrs. Morgens' gross estate under Section 2035(b) because Mrs. Morgens was personally liable for the gift tax as the deemed donor of the QTIP, even though she would have a right of recovery from the Trustees who paid it under Section 2207A(b). The Estate argued that applying Section 2035(b) to the gift tax paid by the Trustees would result in an increased estate tax burden contrary to the legislative intent of the QTIP regime. More specifically, the Estate contended that because the ultimate responsibility for paying the gift tax on the Section 2519 deemed transfers lies with the Trustees of the QTIP trusts, Section 2035(b) does not apply.

The Tax Court agreed that Congress intended that, as between QTIP recipients and the surviving spouse, it is the QTIP recipient who should bear the ultimate financial burden for the transfer taxes. However, the Court does not believe that, by allocating the financial burden for gift tax to the recipients of the QTIP Congress shifted to them liability for the gift tax. Section 2207A(b) does not provide that the donees of the QTIP are liable for the applicable gift tax – rather, it refers to the surviving spouse's right to recover from the donees the gift tax paid. The gift tax liability remains with the donor, and, because the QTIP regime treats the surviving spouse as the deemed donor of the QTIP, the gift tax liability attributable to a Section 2519 deemed transfer remains with the surviving spouse.

Over the Estate's objections, the court found that for purposes of Section 2035(b) the deemed transfer of the QTIP is in this case similar to a net gift. The Tax Court previously held in *Estate of Sachs v. Commissioner* that the phrase "gift tax paid by the decedent or his estate" in Section 2035(c) included gift tax attributable to net gifts made by a decedent during the three-year period before his death, even though the donees of the net gift are contractually obligated to pay the gift tax.

The court also noted that if, as a result of a lifetime disposition of the qualifying income interest, the inclusion of the QTIP uses up some or all of the surviving spouse's unified credit, the surviving spouse may not recover the credit amount from the remaindermen. The court states that Congress' refusal to restore the surviving spouse's unified credit undercuts the Estate's argument that Congress intended to hold the donees liable for the gift tax on gifts of QTIP interests under Section 2519.

The court holds that an exception from Section 2035(b) for gift tax paid on QTIP transfers would encourage transfers of QTIP property in contemplation of the surviving spouse's death, which is inconsistent with the goal of Section 2035(b). Without a clear legislative mandate to except gift tax liability of the surviving spouse on Section 2519 transfers from the application of Section 2035(b), the court would not infer such an exception.

IRS Alerts Taxpayers that it Intends to Issue Guidance under Section 2511(c) – IRS Notice 2010-19 (February 16, 2010)

Section 2511(c) provides that, notwithstanding any other provision of Section 2511 and except as provided in the regulations, a transfer in trust is treated as a transfer of property by gift unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions.

Some advisors interpreted 2511(c) to mean transfers to wholly-owned grantor trusts during 2010 will not be treated as completed gifts for gift tax purposes. IRS Notice 2010-19 clarifies that such an interpretation is incorrect and that gifts to grantor trusts during 2010 may be completed gifts using the same criteria as was in effect on December 31, 2009.

The Notice clarifies that transfers in trust, which would otherwise be subject to gift tax are not excluded from the tax merely because the transfers would not be taxed under Section 2511(c). Section 2511(c) broadens the types of transfers subject to transfer tax to include certain transfers to trusts that, before 2010, would have been considered incomplete and, thus, not subject to the gift tax.

Therefore, a transfer made in 2010 to a trust that is not treated as wholly owned by the donor or the donor's spouse under the grantor trust rules is considered to be a transfer by gift of the entire interest in the property under Section 2511(c). The gift tax provisions in effect on December 31, 2009 continue to apply during 2010 to all transfers made to any other trust to determine whether the transfer is subject to gift tax.

Ludwick v. Comm'r, T.C. Memo. 2010-104 (May 10, 2010)

In this case, the Tax Court held that a contribution of a tenancy-in-common interest in a personal residence to a qualified personal residence trust was entitled to a 17% marketability discount from its full fair market value.

Husband and wife purchased real property in Hawaii as tenants in common. Husband and wife then created separate qualified personal residence trusts and transferred their one-half undivided interests to the trusts. On their gift tax returns, husband and wife valued their separate one-half undivided interests in the property at a 30% discount. The IRS allowed discounts of only 15%.

In its decision, the Tax Court noted its dissatisfaction with the appraisals prepared by both the taxpayers and the IRS. The Tax Court ultimately decided to discount the tenancy in common interest to reflect the cost of partition and the lack of marketability caused by the buyer's inability to sell the property quickly for its full fair market value. Based on its calculations, the Tax Court determined that a discount of approximately 17% should apply.

Step Transaction Doctrine Applies to Aggregate Gifts and Sales to Trusts

In *Pierre v. Commissioner*, T.C. Memo 2010-106 (May 13, 2010), the Tax Court held that the step transaction doctrine applied to collapse the taxpayer's gifts and sales of LLC membership interests to trusts. This case addresses different issues related to the transaction involved in *Pierre v. Commissioner,* 133 T.C. No. 2 (August 24, 2009), whereby the Tax Court held that gifts and sales of membership interests in a single member LLC did not preclude valuation discounts because, for gift tax purposes, the single member LLC was not a disregarded entity.

Twelve days after funding a single member LLC, the taxpayer – on the same day – transferred her entire interest in the LLC to two trusts. The taxpayer gifted a 9.5% interest to each trust, and sold a 40.5% interest to each trust for a promissory note.

The Tax Court collapsed the gift and sale to each trust for valuation purposes and treated the transfers as an aggregate transfer of a 50% interest to each trust. The lack of control discount was decreased from 10% to 8%. The taxpayer's valuation expert admitted that the control discount would be lower for a 50% interest because, for example, it could block the appointment of a new LLC manager. The IRS did not contest the 30% lack of marketability discount.

The Tax Court stated that the main reasons for collapsing the gifts and sale were:

> The gifts and sales occurred on the same day.

> No time elapsed between the gifts and sales other than the time it took to sign four documents.

> The taxpayer intended to transfer her entire interest in the LLC without paying gift tax. There was no non-tax reason for splitting the transfer.

Each trust's capital account in the LLC ledger was labeled "gift transaction."

***United States v. MacIntyre*, S.D. Tex., No. 10-2812, (*complaint filed* 8/6/10) – U.S. government sues estate and donees of J. Howard Marshall II for unpaid gift taxes**

The U.S. government is suing the estate and donees of J. Howard Marshall for a combined $85 million of unpaid gift and GST taxes. The Complaint alleges that between 1993 and 1995 Marshall made more than $109 million in gifts to his ex-wife, son, and various other individuals and trusts. The IRS had previously issued deficiency notices to Marshall's estate for gift and GST taxes, then later entered into stipulations about the amounts owed. Marshall's estate failed or refused to fully pay the debts claimed. Since the estate did not pay, the government claims that the donees of the gifts were automatically personally liable.

In addition to seeking personal liability from all donee trusts and individuals, the government is suing the executors of Marshall's estate, his ex-wife's estate and the trustees of Marshall's and his ex-wife's trusts for personal liability. The government argues that under federal law a personal representative that pays a debt of the decedent prior to paying a government claim is personally liable to the government. Moreover, the government avers that under the relevant state law – Texas – a personal representative must preserve sufficient assets to pay tax liabilities of the decedent in accordance with the priorities established under Texas law and if he or she fails to do so, it subjects the representative to personal liability. The government alleges that the executors and trustees distributed the estates and trusts without paying the government and therefore breached their duties to the government and are personally liable.

The government is also seeking a 10% litigation surcharge under the federal Debt Collection Procedures Act.

Estate and GST Tax Cases

Tax Court Holds Deficiency Notice Invalid where IRS Sends Notice to Address on Estate Tax Return, despite Having Notice of Executor's New Address – *Estate of Rule v. Commissioner, TC Memo 2009-309*

This case addresses the issue of whether the IRS mailed an estate tax deficiency notice to the estate's last known address if the IRS mailed the notice to the address shown on the estate tax return, despite having notice that there was a new address for the executor. The deficiency notice was returned by the postal service marked "Attempted Not Known." The IRS did not issue another deficiency notice after the original one was returned because the deadline for issuing a deficiency notice to the estate had passed.

The Tax Court held that the IRS knew at the time the deficiency notice was issued that the estate's address had changed, and that the IRS therefore failed to use reasonable care and diligence in mailing the notice to the estate's last known address. The deficiency notice was held to be invalid, and, accordingly, the estate's motion to dismiss for lack of jurisdiction was granted.

Estate is Not Entitled to an Estate Tax Charitable Deduction for the Amount Received by a Charitable Trust Pursuant to a Settlement Agreement — PLR 201004022 (September 15, 2009)

The IRS held that an estate was not entitled to an estate tax charitable deduction for the amount paid to a charitable trust pursuant to a settlement agreement.

The Decedent's Will made a number of specific bequests and created trusts for his son and other relatives which provide that the remainder interest in the trusts are distributable to a charitable trust which he created. However, the Will contained no residuary estate provision.

The Decedent's sole heir was his son who argued that he was entitled to the Decedent's residuary estate. The charitable trust argued that the omission of the residuary clause from the Will was a scrivener's error and that the Decedent's intent was to leave his residuary estate to the charitable trust. The attorney who drafted the Will confirmed this in an affidavit. After months of negotiations, the son and the charitable trust settled the dispute and executed a settlement agreement.

The issue presented in this ruling was whether the estate could take an estate tax deduction for the amount payable to the charitable trust under the settlement agreement.

The IRS determined that it has been established that the parties to a settlement agreement are only entitled to federal estate tax deductions to the extent that they have an enforceable right under properly applied state law. Therefore, the question was whether the charitable trust had an enforceable right under state law to receive the payment under the settlement agreement.

Although there is a preference under the applicable state law not to allow the passing of an estate through intestacy, when there is a valid Will, there is also a presumption that heirs of an estate are not to be disinherited unless it is through the plain language in the Will. Additionally, although a court is allowed to consider external evidence when interpreting a Will, that evidence is only allowed when the Will is ambiguous.

Since the Decedent's Will did not conflict with the distribution of the residuary clause through intestacy, there was no reason under state law for the court to examine extrinsic evidence such as the attorney's affidavit.

Therefore, the IRS held that the charitable trust was not entitled to the settlement proceeds under applicable state law and the estate was not entitled to the charitable deduction for the settlement amount.

Federal Court of Claims Holds that Primary Executor of Estate Was Not Entitled to Reissuance of $10 Million Refund when Check Was Previously Issued to and Negotiated by an Ancillary Executor – *Curtin v. United States*, Fed. Cl. No. 09-109 T (February 26, 2010)

The Federal Court of Claims recently denied a U.S. executor's claim for a federal tax refund when the IRS had previously issued a refund check to a non-U.S. ancillary executor. At issue was the estate of a deceased U.S. citizen who died domiciled in France. Unrelated individuals, the Plaintiffs, administered her estate in the U.S. The decedent"s son served as an ancillary executor in France.

The U.S. executor initially paid from the estate about $17.5 million in federal estate taxes and requested an extension of time to file along with the payment of the tax. Subsequent to this, the son filed an estate tax return claiming a $10 million refund, which the IRS paid to him. The son's agent negotiated the check.

The U.S. executor subsequently filed for a $5 million refund, which was denied on the basis that the refund had already been paid. The U.S. executor filed suit, claiming that the check was forged or fraudulently negotiated and the IRS breached an implied in fact contract between it and the U.S. executor. The Court of Claims disagreed. Because the check was issued to the son and duly negotiated, no forgery or fraud was present. Moreover, the court held that the U.S. executor failed to establish a basis for an implied in fact contract.

IRS Announces Two-Year Renewal of Art Advisory Panel (February 23, 2010)

The IRS recently announced its decision to renew for an additional two years the charter for the Art Advisory Panel. The Art Advisory Panel assists the IRS by reviewing and evaluating the acceptability of appraisals submitted by taxpayers with respect to the fair market value of art. Membership on the Panel is comprised of museum directors, curators, art dealers and auction representatives.

The Art Advisory Panel has played an important role in the eye of many courts deciding issues of art valuation in federal tax cases. For example, in *Stone v. United States*, 99 AFTR.2d 2007-2992, aff'd, 103 AFTR.2d 2009-1379, the court emphasized that the Panel represented a "collection of experts" and found that on account of the fact that the members are not paid and are not told the purpose of the valuation (e.g., income tax valuation versus transfer tax valuation), the Panel is "extremely credible" and "unbiased." Critics point to the close-knit nature of the art community in questioning whether the Panel's evaluations are actually all that unbiased. Nonetheless, the Panel is here to stay, at least for the next two years.

6th Circuit Finds Regulation Reasonable on Generation-Skipping Transfer Tax – *Estate of Timken*, 2010 WL 1253627 (April 2, 2010)

The 6th Circuit found that Treasury Regulation §26.2601-1(b)(1)(v)(A), stipulating that the grandfathering exemption to the generation-skipping transfer tax ("GST") does not apply when there is a post-statute exercise of lapse of a general power of appointment, is reasonable.

The Timken estate trust became irrevocable in 1968, before passage of the GST, with the death of the Settlor ("Timken"). The trust granted Timken's widow a general power of appointment over trust assets, and, provided that if the power lapsed, the remaining assets would be divided for Timken's nieces and nephews. The widow died in 1998 without appointing successors and, consequently, her general power lapsed. The trust assets passed to Timken's nieces, nephews, grandnieces and grandnephews.

The court noted that §2601 is ambiguous as to whether the grandfathering exemption applies to an irrevocable trust that does not mandate a generation-skip, but permits a beneficiary to use a discretionary power of appointment to make a generation-skipping transfer. Treasury Regulation §26.2601-1(b)(1)(v)(A) permits application of the GST to post-statute exercises and lapses of general powers of appointment.

The court found that the regulation resolves the statutory ambiguity in the same way as other regulatory amendments and is therefore reasonable.

No Estate Tax Apportionment against Payable on Death Accounts

In *Estate of Sheppard v. Schleis*, 2010 WI 32 (Wis. May 4, 2010), the Wisconsin Supreme Court ruled that, in the absence of any tax apportionment directions by the decedent, a beneficiary of a payable-on-death account is not liable for any estate tax imposed on the decedent's estate.

The decedent died without a Will. Other than the payable-on-death accounts which passed directly to the beneficiary, the decedent's estate passed by probate to his heirs at law.

The executors of the decedent's probate estate sought reimbursement from the beneficiary of the payable-on-death accounts for the portion of federal and state estate taxes attributable to those accounts.

The executor first argued that payable-on-death accounts fall under Internal Revenue Code ("IRC") Section 2036 because the decedent had a retained interest in those accounts. If the decedent had a retained interest under IRC § 2036, the executors could exercise their right to recover estate taxes under IRC § 2207B. However, the court rejected this argument, stating that payable-on-death accounts do not fall under IRC § 2036 because the decedent did not relinquish any rights to the accounts during his lifetime and the beneficiary did not possess a remainder interest during the decedent's lifetime.

The executor also argued that, since Wisconsin does not have an estate tax apportionment statute, there is a common-law right to equitable apportionment of estate tax. The court rejected this argument also, stating that in the absence of any tax apportionment directions by the decedent, estate taxes are to be paid from the residuary estate.

New York and Florida Joins Sixteen Other States in Enacting Formula Clause Fixes

State legislatures are catching the ball that the Federal legislature dropped in permitting the Federal estate and generation-skipping transfer ("GST") taxes to lapse in 2010. New York and Florida are now among eighteen states that have enacted legislation that addresses the interpretation of dispositive instruments that include formula clauses. In New York, for decedents who die in 2010, any bequest that is based on the amount that can pass free of Federal estate or GST taxes shall be read as though the Federal law in effect on December 31, 2009 still applied. In Florida, a fiduciary or any beneficiary can bring an action to have a Court construe the document in accordance with the Settlor's intent.

New Jersey Federal District Court Finds that the IRS Abused its Discretion in Disallowing Extension of Time to File Estate Tax Return

In *Estate of Proske v. United States*, Civil Action No. 09-CV-670 (DMC) (USDC D.N.J. May 25, 2010), the New Jersey District Court found that the IRS abused its discretion in disallowing the estate an extension of time to file its Federal estate tax return.

The executor of the estate failed to file an estate tax return and a request for an automatic six-month extension of time to file the return within nine months of the decedent's date of death. The extension request was filed approximately one month after the estate tax return due date, together with payment in the amount of $1,800,000 for the estimated tax. The attachments to the Form 4768 extension request explained that the filing delay was due to the (1) the estate's lack of sufficient liquid assets to make payment, (2) a difficulty in calculating the marital deduction and, thus, the taxable estate, and (3) a delay in obtaining appraisals for certain estate assets. During the course of litigation, the executor of the estate further explained that she was concerned that she could not certify, under penalty of perjury, the information required to be reported in Form 4768.

The IRS denied the extension request simply because the "application was filed after the due date for the return." When the estate did file the return, the IRS assessed a $305,130 late filing penalty with interest which the estate paid but then sought to have refunded to it. The case came before the District Court upon cross-motions for summary judgment which the Court ultimately granted to the estate. In so doing, the Court noted that, pursuant to Treasury Regulation Section 20.6091-1(c), the IRS has the discretion to grant an extension of time to file a return even if an automatic extension request is not timely filed if, *inter alia*, it was impossible or impracticable to file a reasonably complete return when due.

The Executor argued that the estate had shown good cause for the delay which the IRS, in an abuse of its discretion, failed to consider. The Court agreed, noting that there was no record of whether or how the IRS had considered the estate's explanation for the filing delay. As a result, the Court stated that the estate tax return is to be treated as having been timely filed and the refund request is to be granted.

Estate of Stewart v. Commissioner, 2d Cir., No. 07-5370-ag (8/9/10) – Court finds Tax Court erred when it apportioned entire value of a Manhattan brownstone to a Decedent's estate when Decedent transferred 49% of the property to her son a few years before her death

In this case the higher court reversed a lower court's inclusion of the entire value of a real property in the Decedent's estate when the decedent had transferred a portion of the property to her son during her life.

Specifically, prior to her death the Decedent transferred a 49% interest in a Manhattan brownstone to her son who lived with her on 2 of the floors. The Decedent and her son continued living on 2 of the floors until the Decedent's death and leased the other 3 floors to a tenant. All income and most expenses on the rental portion were paid to and borne by the Decedent for the rest of her life.

The son argued there was an agreement to reconcile the income and expenses of the brownstone to a property in East Hampton that was also co-owned by them. In prior years tenants in the East Hampton property would pay either the Decedent or her son, then they would split the money every few months. After the transfer of the 49% in the brownstone, the Decedent received all income from the tenant in the brownstone and paid most of the expenses, but the son received all rent from the East Hampton property and did not split the proceeds with the Decedent.

The tax court found there was an implied agreement of retained enjoyment and included the entire property in the Decedent's estate under §2036.

The higher court vacated the lower court's ruling. This court stated that "co-occupancy of residential premises by the donor and donee is highly probative of the absence of an implied agreement." The Court also explained that two factors are particularly significant in determining whether there is an implied agreement for retained possession or enjoyment of a residential property: (i) continued exclusive possession by the donor and (ii) withholding possession from the donee.

The higher court found that the son enjoyed the benefits of the residential portion of the 49% and at least some of the benefits of the rental portion and remanded for a determination of how much of the rental portion the decedent retained. The benefits to the Decedent's estate is a potential 42.5% discount for lack of control and marketability and the exclusion of $125,000 of appreciation from the estate.

Estate of Stick v. Commissioner, T.C., No. 16383-08, T.C. Memo. 2010-192 (9/1/10) – Loan interest paid by Trust held nondeductible in decedent's estate because it was unnecessary

After Decedent's death, his trust borrowed $1.5 million from Decedent's Foundation to pay his estate tax liabilities (aka a "Graegin" loan). The trust claimed deductions for the interest on the loan under IRC §2053.

The IRS would not allow the deductions because the estate had sufficient liquid assets to pay its estate tax liabilities and the Regulations only allow deductions of administrative expenses that are actually and necessarily incurred in the administration. The Court agreed that since there were sufficient liquid assets, it was not necessary to take out the loan and the interest was therefore nondeductible.

Estate of La Caer v. Commissioner, 135 T.C. No. 14 (9/7/2010) – Court limits amount that surviving spouse was entitled to claim for tax on prior transfers under §2013

This case involves credits for tax on prior transfers under IRC §2013. The credit amount varies based on the number of years between the two taxpayers' deaths. In this case husband died first and his wife died three months later. Under §2013, if the taxpayers died within 2 years of each other, the credit amount is the lesser of two limits. The first limit is the amount of the federal estate tax attributable to the transferred property in the estate that has already been taxed. The second limit is the amount of the federal estate tax attributable to the transferred property in the estate that has not yet been taxed.

The husband's personal representatives purposely caused certain of the husband's assets to not qualify for the marital deduction and therefore be taxed in the husband's estate. The husband's estate paid approximately $200k federal estate tax and $25,000 in Nevada estate tax. The Nevada estate tax is a "pickup" or "sponge" tax in that Nevada imposes a tax in the amount of the maximum credit allowable against the federal estate tax for payment of state death taxes.

The wife's estate claimed a credit in the full amount of all death taxes paid by the husband's estate, without taking into account any limits under §2013. The estate argued that the only portion of the husband's estate that was subject to estate tax was the nonmarital portion and, therefore, the limitations on the tax credit were not triggered when the husband passed no other property subject to the estate tax. The estate argued further that since the Nevada tax was essentially a portion of the federal tax paid to the state, it should also be given a credit. The tax court rejected both arguments, stating that the limitations apply and the state tax was not entitled to a credit.

The wife's estate also filed an amended return in which it deducted the husband's estate tax payment as a debt of the wife. The tax court also denied this deduction because the wife's estate did not introduce any evidence showing that the taxes were actually paid with assets in the wife's estate.

Cases Involving Formula and Defined Value Clauses

Eighth Circuit Upholds Formula Disclaimer Over Public Policy Objections - *Estate of Christiansen v. Commissioner*, 104 AFTR 2d 2009-7352 (8th Cir. 2009)

In a unanimous decision, the Eighth Circuit upheld over the IRS' public policy objections a formula disclaimer which passed property to charity. This is an important case, as its holding might be broadly applied not just to formula disclaimers passing property to charity, but to defined value clauses in general, including those used in conjunction with gifts or sales of business interests to intentionally defective grantor trusts.

In her will, a decedent left her entire estate to her daughter. The will provided that any disclaimed assets were to pass 75% to a CLAT and 25% to a private foundation. The daughter made a formula disclaimer, in effect disclaiming a fractional share of the decedent's estate exceeding $6.35 million. The decedent's estate tax return reported the estate's value at just over $6.5 million. Based on that value, about $120,000 was to pass to the CLAT and about $40,000 was to pass to the foundation. On audit, the IRS and the estate agreed to increase the gross estate from $6.5 million to $9.6 million (based largely on adjustments to discounts that the estate took on limited partnership interests). Pursuant to the disclaimer, the additional $3.1 million of estate tax was to pass to the CLAT and foundation as if there were no additional tax.

The Tax Court held that the 75% disclaimer to the CLAT was not a qualified disclaimer due to technical violations of the Disclaimer Regulations. That finding was not at issue in the appeal.

With respect to the 25% passing to the foundation, the IRS allowed the $40,000 charitable deduction for the pre-adjustment disclaimer amount, but not for the additional amount passing to the foundation as a result of the adjustment. The IRS made two arguments against the increased deduction. First, it argued that any increased amount passing to the foundation was not deductible because it was contingent on the determination of the final estate tax value, and the Regulations provide that a charitable deduction is not available where it is "dependent upon the performance of some act or happening." The court rejected that argument, finding that while the <u>transfer</u> must be complete at the date of the decedent's death, there does not necessarily need to be an agreement on the <u>value</u> of the transfer at that time. In this case, the foundation's right to receive 25% of the disclaimed amount was certain; the only thing that was uncertain was the value of that 25%.

The IRS's second argument was the same argument that the IRS made successfully in *Proctor v. Commissioner*, 142 F.2d 824 (4th Cir. 1944)—that is, that the transfer violated public policy because it reduced the IRS' incentive to audit the return. The court rejected this argument as well, even though the formula disclaimer "may marginally detract from the incentive to audit" and, in some situations, would permit a charitable deduction equal to the entire increase in the value of the estate. The court gave three reasons for its holding. First, it noted that the IRS' role is not merely to maximize tax receipts, but to enforce the tax laws. Second, there is no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the IRS to audit returns; on the other hand, there is a clear policy of encouraging charitable donations by allowing charitable deductions. Third, there are other mechanisms that offset the decreased incentive to audit, including (a) the executor's fiduciary duty to accurately report estate values and (b) the contingent beneficiary (in this case the foundation) having an interest in ensuring that the executor does not underreport the value of the estate. Accordingly, the Eight Circuit affirmed the Tax Court's holding that the formula disclaimer clause was not against public policy, and that the estate was entitled to a deduction for the full amount passing to the foundation.

Tax Court Upholds Defined Value Gift in which LLC Interests Given to the Donor's Children and Charities. - *Estate of Petter v. Commissioner*, TC Memo 2009-280

On the heals of *Christiansen*, the Tax Court upheld a defined value clause over the IRS' public policy objections, this time in the context of a part-gift, part-sale of LLC interests. As with *Christiansen*, this is an important taxpayer victory in the defined value clause arena.

Anne Petter inherited a large amount of UPS stock from her uncle. She consulted an estate planner who recommended a number of techniques to meet her goals, including (a) involving her children in the management of her newly acquired wealth and (b) providing for local charities. One of those techniques involved having Anne contribute all of her UPS stock to an LLC. Anne also created two defective grantor trusts, one for each of her children. She transferred LLC units to each child's trust, partly as a gift and part as a sale. The gift portion was stated as amount equal to 10% of the trust's assets, and the sale portion was stated as 90% of the trust's assets. In addition, Anne donated LLC interests to two local charities.

A formula clause was used to divide the LLC interests between the trusts and charities. The transfer to each trust was stated as "the number of units that equals one-half of the maximum dollar amount that can pass free of federal gift tax." As part of the transfer documents, the trustees of the trusts agreed, as a condition of the gift, that if the value of the units it received was finally determined for gift tax purposes to exceed the originally determined amount, then it would transfer the excess to the charities. The sale to each trust was stated as "the number of units that equals a value of $4,085,190 as finally determined for Federal estate tax purposes," with any excess passing to the charities. Again, the trustees of the trusts agreed, as a condition of the sales, that if the value of the interests were adjusted upward, they would transfer additional LLC interests to the charities. Similarly, the charities agreed that, in the event of any downward adjustment, the charities would transfer a portion of the LLC interests to the trusts.

The LLC units were valued by a qualified appraiser who determined that a discount of over 50% was appropriate, and the LLC units were allocated among the trusts and charities accordingly. On audit, the IRS disallowed a significant portion of the discount, which had the result of increasing the amount passing to the charities based on the formula clauses. The IRS also disallowed any increase in the charitable deduction and asserted that the sales were for less than adequate and full consideration, resulting in gift tax.

Again, the IRS argued that the formula clause was void against public policy based on *Proctor*. The Tax Court did not agree, finding that this case was closer to *Christiansen* (in which a donor gave away a fixed set of rights with uncertain values) than *Proctor* (in which the donor tried to take property back). The plain language of the transfer documents showed that the taxpayer was making gifts of an ascertainable dollar value of LLC units, rather than a specified number of units. The facts also showed that the charities were advocating their own interests, not just passively helping the taxpayer reduce her tax bill. The charities conducted arm's-length negotiations, retained their own counsel, and won changes to the transfer documents to protect their interests. In addition, the directors of the charities owed fiduciary duties to their organizations to make sure that the appraisal was acceptable before signing off on the gift. Thus, the court held that (a) the formula clause was valid, (b) the sales did not result in additional gifts and (c) an additional charitable deduction was warranted for the reallocated amount passing to charity.

Life Insurance Cases

Life Insurance Proceeds Received by Limited Partnership Not Included in Gross Estate of Insured Limited Partner - PLR 200947006 (Nov. 20, 2009) & PLR 200948001 (Nov. 27, 2009)

In Private Letter Rulings 200947006 & 200948001, the IRS considered whether a series of transactions among a partnership, corporations and trusts which altered the ownership and beneficiary designations of two life insurance policies required inclusion of the policies in the insured's estate.

At the outset, the partnership's sole asset was life insurance on the taxpayer's life. The general partner of the partnership was a corporation that was wholly owned by the insured. The limited partners of the partnership included the insured and a second corporation. The second corporation was owned by a trust formed by the insured's parents. The trustees were the insured and his sister. The sole current beneficiary was the insured. The insured did not have any power of appointment. Upon the insured's death, the trust assets were to pass in trust for his descendants.

The insured, the partnership, the corporations and the trusts proposed entering into a multi-step transaction, which would result in the partnership still owning the life insurance; however, the partnership would be owned by the trust created by the insured's parents, plus another trust formed by the insured for the benefit of his wife and children. The insured would remain a co-trustee of the trust created by his parents, but he would release to his co-trustee/sister all powers to make decisions with respect to the insurance. The first trust would contribute cash to the partnership in an amount estimated to cover the premiums on the policies for the rest of the insured's life.

The IRS held that policies were not includible in the insured's estate because he would hold no incidents of ownership either before or after the transactions. The IRS relied on *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), in which a decedent was a 50% general partner in a partnership that owned and was the beneficiary of ten life insurance policies on the decedent's life. In *Knipp*, the Tax Court found that the partnership bought the policies in the ordinary course of business and that the decedent, in his individual capacity, had no incidents of ownership. Therefore, the policies were not includible in his estate. Prior to Private Letter Rulings 200947006 & 200948001, some practitioners believed that a partnership might not be able to benefit from *Knipp* unless there was a business purpose for holding the insurance. However, the partnerships in the Private Letter Rulings had no assets apart from the insurance, which suggests that a business purpose for ownership of the policies is not necessary.

Tax Court Finds that Value of Life Insurance Policy Sold from Profit-Sharing Plan to the Insured is Determined by Reference to the Policy's "Entire Cash Value," which Allows no Reduction for Surrender Charges, thereby Resulting in Taxable Income from Bargain Sale – *Matthies v. Commissioner*, 134 T.C. No. 6 (February 22, 2010)

At issue in *Matthies* was whether taxable income resulted from the sale of a second-to-die life insurance policy by the profit-sharing plan of the taxpayers' wholly owned subchapter S corporation to the taxpayers.

In October of 1998, the taxpayers incorporated their subchapter S corporation and formed its profit-sharing plan. In January of 1999. the plan purchased an $80 million second-to-die life insurance policy on the lives of the taxpayers. During 1999 and 2000, the taxpayers transferred over $2.5 million from an IRA to the profit-sharing plan. These contributions were used to pay the premiums on the life insurance policy. Then, in December of 2000, the profit-sharing plan sold the policy to the taxpayers for about $315,000. At the time of the sale, the "cash value" of the policy was about $306,000, but the "account value" was almost $1.4 million. The difference between the "cash value" and the "account value" was a result of a surrender charge that would be imposed upon the policy if surrendered within the three years after issuance.

The taxpayers then transferred the policy to a "family irrevocable trust." In January of 2001, the trust exchanged the policy for another survivor policy with a face amount of $19.5 million. As part of the exchange, the life insurance company waived the surrender charge and accepted the $1.4 million "account value" as full payment for the new policy.

Because the sale of the policy was not negotiated at arm's length, the Tax Court considered the proper method for valuing the policy for purposes of determining whether the taxpayer's realized taxable income from a bargain sale. In this regard, the essential question was whether the surrender charge should be taken into account in valuing the policy, or, in other words, whether fair market value of the policy was its "cash value" or its "account value." The court reviewed statutory and regulatory language from IRC Sections 72, 402 and 7702 and determined that for purposes of calculating the taxpayers' income from the bargain sale, the value of the policy should be determined without reference to the cash surrender value. Accordingly, the court held that the taxpayers recognized about $1.1 million of taxable income from the transaction. However, in light of ambiguity as to the proper tax treatment of the transaction, the court declined to assess a negligence penalty against the taxpayers.

Tax Court Finds that Termination of Variable Life Insurance Policy against which Taxpayer had Borrowed Did Not Result in Cancellation of Indebtedness Income, but rather in Taxable Distribution of the Policy's Cash Surrender Value – *McGowen v. Commissioner*, T.C. Memo 2009-285 (December 14, 2009)

In *McGowen v. Commissioner*, the Tax Court found that the termination of a variable life insurance policy resulted in a taxable distribution of the policy's cash surrender value. From 1989 until the termination of the policy in 2003, the taxpayer continually borrowed against the cash surrender value of her variable life insurance policy. As the debt against the policy grew, together with accrued interest, the life insurance company terminated the policy and used its cash surrender value to satisfy the taxpayer's debt. The insurance company issued the taxpayer a 1099 reporting about $565,000 in income

At issue was the characterization of the income. The taxpayer argued that the income was a result of cancellation of indebtedness. Characterization as such would have permitted the taxpayer to avail herself of the provisions of IRC Section 108 and exclude the amount from gross income. However, the Tax Court disagreed with this characterization. The court found that the debt was not extinguished; rather, the insurance company had applied the cash surrender value of the policy against the debt. This constituted an indirect distribution under IRC Section 72. Accordingly, the taxpayer was not entitled to an exclusion from gross income.

Disclaimer Cases

Disclaimer Allowed for Pre-1977 Trust Interest within Nine Months of Disclaiming Beneficiary Reaching Majority as "within a Reasonable Time" under Law Applicable Prior to Section 2518 - PLR 200953010 (Dec. 31, 2009)

This PLR involves a requested ruling on the gift tax consequences of a taxpayer's proposed disclaimer of a contingent remainder interest in an irrevocable trust created prior to January 1, 1977.

The taxpayer is a great-grandchild of the Grantor. The Trustees may make principal and income distributions to or for the benefit of the Grantor's child and the descendants of that child in the event of illness, accident, other misfortune or any emergency, or if, in the Trustee's judgment, distributions are necessary for the beneficiaries' comfortable maintenance, support or education. The taxpayer previously had received discretionary distributions from the Trust. The Trust terminates 20 years after the death of the survivor of the Grantor's descendants living on the date the Trust was funded, and on termination, the remaining principal is distributed to the descendants of the Grantor's child who have no living ancestor who is a descendant of such child, per stirpes.

The taxpayer proposes to disclaim her right to receive any distribution from the Trust upon its termination, though she will retain her right to receive discretionary distributions during the Trust term. The disclaimer will be executed by the taxpayer within nine months after attaining majority.

Whereas Section 2518 and the related Treasury Regulations govern disclaimers of interests in property created by transfers made after December 31, 1976, Treasury Regulation Section 25.2511-1(c)(2) provides that, in the case of transfers made before January 1, 1977, a refusal to accept ownership does not constitute the making of a gift if the refusal: (1) is unequivocal; (2) is effective under local law; (3) is made before the disclaimant has accepted the property; and (4) is made within a reasonable time after knowledge of the existence of the transfer creating the interest to be disclaimed.

In the case of a disclaimer of an interest in trust, in general, the transfer occurs when the trust is established rather than when the interest actually vests in the disclaimant, if the transferor has not reserved any power over the trust. However, the time limitation for making the disclaimer does not begin to run until the disclaimant has attained the age of majority and is no longer under a legal disability to disclaim. In this case, the Service concluded that the proposed disclaimer, occurring nine months after the taxpayer reached majority, would be considered to satisfy the "within a reasonable time" standard of Treasury Regulation Section 25.2511-1(c)(2).

***Breakiron v. Guidonis*, 2010 WL 3191794 (D. Mass. 8/10/2010) – Court rescinds nonqualified disclaimer and denies gift tax liability**

In this case, a disclaimant's parents set up Qualified Personal Resident Trusts ("QPRTs") that passed to the disclaimant, Craig, and his sister after the QPRT terms expired. Craig wanted to transfer his interest in the QPRTs to his sister and consulted with an attorney on the gift tax implications. The attorney incorrectly advised Craig that he could make a qualified disclaimer as long as he completed it within 9 months of the expiration of the QPRTs' terms. However, the disclaimer actually had to be completed within 9 months from the creation of the QPRTs. Due to the error the disclaimer was unqualified and Craig owed $2.5 million of gift tax liability.

Craig tried to rescind the disclaimer under the applicable state law (Massachusetts) and named the IRS as a party to the suit. Massachusetts law allows a written instrument to be rescinded on the grounds of mistake when there is full, clear, and decisive proof of the mistake. Massachusetts case law also has specifically recognized that a disclaimer may be rescinded if it was executed because of a mistake which frustrated its purpose.

The Court found that since the IRS was named as a party to the case and because the disclaimers were rescindable under the applicable state law, the disclaimers should be rescinded and no gift tax imposed.

Probate Litigation

California Appeals Court Holds That Fees Incurred Defending Trust Beneficiaries' Bad Faith Claim Were Properly Charged Against Those Beneficiaries' Shares of the Trust. - *Rudnick v. Rudnick*, 2009 SOS 6928 (Cal. App. 5th Dist.)

In this case, a California Appeals Court considered whether fees incurred by a trust in defending against certain trust beneficiaries' bad faith claim to block the sale of trust property were properly chargeable against the entire trust or just the shares of the beneficiaries who brought the bad faith claim.

Under a trust agreement, any sale or disposition of certain trust property, once negotiated by the trustee, had to be approved by a majority of the trust beneficiaries for it to become effective. The trustee proposed the sale of a ranch, which was the trust's primary asset. The sale was approved by a 60% majority of the beneficiaries, but the beneficiaries in the 40% minority continued to file pleadings to enjoin the sale of the ranch. Accordingly, the trustee filed a petition in the Probate Court to obtain instructions to complete the sale and to approve a distribution of the proceeds to the beneficiaries. The court approved the sale and distribution plan. Thereafter, the trustee filed a motion to recover the attorney's fees and costs incurred in connection with the petition for instructions, and to charge that amount against the minority beneficiaries' shares of the sales proceeds.

The Probate Court found that the minority beneficiaries' opposition to the petition for instructions was not made in good faith; that their primary motivation was to disrupt the sale by preventing the trustee from closing by the due date that had been arranged with the buyer. Thus, the Probate Court held that, under the circumstances, it was not fair to burden all of the beneficiaries, including the majority beneficiaries, with the payment of the fees. Therefore, it ordered that the fees be paid only from the minority beneficiaries' shares of the sales proceeds. The Court of Appeals found that the Probate Court did not abuse its discretion, in that the court did have the equitable power to order that the attorney's fees be paid from the minority beneficiaries' shares only.

Decedent Had No Ownership Interest in Companies Despite His Involvement in the Business

In *Estate of Fortunato v. Commissioner*, T.C. Memo 2010-105 (May 12, 2010), the Tax Court ruled that the decedent had no ownership interest in various companies despite his involvement in the operation of the companies.

The decedent's brothers started a group of warehouse companies. The decedent became involved in running some of those companies. During business dealings, the decedent held himself out as the owner or the CEO. However, he had no documented ownership interest in any of the companies, and he did not provide any of the initial or subsequent infusions of capital. As such, the executors did not report an ownership interest in the companies on the decedent's estate tax return.

The IRS determined a deficiency in the federal estate tax paid; it asserted that the decedent held an interest in the companies as a beneficial owner because he created the business strategies for the companies, controlled the companies' finances, had the companies' employees report to him, and held himself out as the business owner.

Although the applicable state laws allowed a legal owner of a corporation to be an uncertified shareholder, the Tax Court held that the facts showed the decedent did not exhibit any intent to become a shareholder nor did the corporation exhibit an intent to make the decedent an owner. The decedent never wanted to become a shareholder because he was afraid his creditors would attempt to collect on his debts and he was worried his past criminal convictions would stigmatize the companies. Furthermore, the decedent's brothers thought the decedent was irresponsible despite his business acumen.

Privity No Longer an Absolute Defense in New York

As we previously reported in a special edition of *Wealth Management Update*, the New York Court of Appeals recently issued a decision in *Estate of Schneider v. Finmann,* 2010 N.Y. Slip Op. 05281 (N.Y. June 17, 2010), a case involving the applicability of New York's strict privity defense in an estate planning malpractice claim. In what is sure to cause every estate planning attorney and personal representative to take note, the Court of Appeals held that a personal representative may maintain a legal malpractice claim for estate losses resulting from negligent estate planning representation.

By way of background, in New York, a third party, without privity, generally cannot maintain a claim against an attorney in professional negligence. This strict privity rule has been applied to estate planning malpractice lawsuits, effectively protecting estate planning attorneys from suits commenced by personal representatives or beneficiaries. However, this rule also left a decedent's estate with no recourse against a negligent estate planning attorney. Recognizing this, the Court of Appeals has carved out an exception to the privity rule.

In *Estate of Schneider*, the decedent retained the services of an attorney for estate planning advice. Thereafter, the decedent transferred ownership of a $1 million life insurance policy to himself, individually, from a family limited partnership he controlled. When the decedent died, the insurance proceeds were, predictably, subject to estate tax. The decedent's estate commenced a malpractice action, alleging that the estate planning attorney negligently advised the decedent to transfer (or failed to advise the decedent not to transfer) the policy, which resulted in increased estate tax. The trial court granted the attorney's motion to dismiss the estate's complaint for failure to state a cause of action. The Appellate Division affirmed, holding that, in the absence of privity, the estate may not maintain an action for legal malpractice.

The Court of Appeals then reversed the decision, finding that privity does exist between a personal representative and the estate planning attorney. In siding with other jurisdictions that have a relaxed privity rule, the Court noted that "the estate essentially 'stands in the shoes' of the decedent" and, therefore, "has the capacity to maintain the malpractice claim on the estate's behalf." This decision, however, does not completely strike down the privity defense; the Court noted in its decision that strict privity remains a bar against estate planning malpractice claims brought by beneficiaries or other third-party individuals (absent fraud or other special circumstances).

In short, a personal representative is no longer prevented from raising a negligent estate planning claim against the attorney who caused harm to the estate. As a result, a personal representative may now need to review the estate planning advice given to the decedent during his or her lifetime to determine whether any such claim exists and should be pursued.

The Ninth Circuit Holds That an IRA's Named Beneficiaries, Rather Than the Decedent's Wife, Were Entitled to the IRA Funds After His Death, Even Though Some of the Funds in the IRA Had Been Rolled Over From a 401(k) Plan Subject to ERISA's Surviving Spouse Provisions – *Charles Schwab & Co. v. Debickero*, 105 AFTR 2d (9th Cir., January 22, 2010)

The Ninth Circuit held that the named beneficiaries of an IRA, rather than the IRA owner's wife, were entitled to the IRA funds after his death, even though some of the funds in the IRA had been rolled over from a 401(k) plan subject to ERISA's surviving spouse provisions.

Wayne Wilson was a participant of his employer's 401(k) plan until 1992. In 1994, while employed with another company, Wilson elected to close his 401(k) plan and take a lump sum distribution which he rolled over into an IRA with Smith Barney.

After having lived together since 1990, Wilson married Katherine in 2000. In June 2002, Wilson opened another IRA with Charles Schwab, which he funded by transferring one-half of the proceeds from the Smith Barney IRA. Despite his marriage to Katherine, Wilson told Schwab that he was divorced and named his four adult children from a prior marriage as the primary beneficiaries of his IRA.

In 2005, Wilson died unexpectedly in a flash flood. He was survived by Katherine and his four adult children who asserted competing rights to the funds. Schwab filed an action naming Katherine and the children as defendants. Katherine argued that she was entitled to the funds as the surviving spouse under either ERISA or the Code.

The district court granted summary judgment in favor of the children and Katherine appealed to the Ninth Circuit. Katherine argued that ERISA excludes from coverage only self-funded IRAs and not IRAs containing funds that originated as employer contributions to an ERISA covered plan.

The Ninth Circuit rejected Katherine's arguments and affirmed the district court's grant of summary judgment and held that ERISA's surviving spouse protections apply only when an ERISA-qualified plan is involved. In this case, ERISA ceased to apply when, long before his marriage to Katherine, Wilson terminated his participation in the 401(k) plan and transferred the proceeds to the IRA.

Surviving Spouse is not Treated as the Payee of the Decedent's IRA and Therefore Could Not Take the IRA and Roll It Over Into an IRA in Her Own Name – PLR 200944059 (August 3, 2009)

In this PLR, the IRS found that the Decedent's surviving spouse was not treated as the payee of the Decedent's IRA, and therefore she could not take the IRA and roll it over into an IRA in her own name.

The Decedent died in 2004 survived by his wife and son. The Decedent named a trust as the beneficiary of his IRA. The IRA was the only asset of the trust and the Decedent's wife was named as the sole trustee. The trustee is authorized to pay discretionary income and principal to the Decedent's wife for her maintenance, support and health. Any income not distributed is to be added to principal. Upon the Decedent' wife's death, the remaining principal is to be distributed to the Decedent's son, if he survives the wife, or, if he predeceases her, to his then living descendents, per stirpes, or, in default thereof, to the Decedent's nephews and nieces.

After the Decedent's death, a controversy arose among the Decedent's wife, son and nieces and nephews. The Decedent's wife petitioned the state court for a declaratory judgment that she has the discretion, as trustee, to withdraw the balance from the IRA and distribute it to herself, individually, in order for her to rollover the IRA into an IRA in her own name. The court granted the declaratory judgment.

In this ruling request, the Decedent's wife represented that she will roll the IRA into an IRA in her own name and will then make an irrevocable beneficiary designation consistent with the trust terms on her death.

The IRS noted that "generally, under certain conditions, if either a decedent's plan or IRA proceeds pass through a third party, e.g., a trust, and then are distributed to the decedent's surviving spouse who is entitled to receive the distribution, said spouse will be treated as acquiring them directly from the decedent." In those cases, the spouse could take the distribution and roll it into her own name.

However, the IRS determined that the Decedent's wife did not have the power to withdraw the entire balance of the IRA either under state law or pursuant to the trust terms because she was limited to distributions subject to an ascertainable standard.

The IRS stated that it is not bound by the state court order because it is not the highest court in the state, and is contrary to prior decisions by the highest court in the state. Accordingly, the court order is not controlling for federal tax purposes, and any withdrawal by the Decedent's wife of the IRA would be unauthorized for federal tax purposes. In addition, if the remainder beneficiaries agreed with such withdrawal, they may be treated as having made a taxable gift under Section 2501.

In making its ruling, the IRS concluded that (1) the Decedent's IRA will be considered an inherited IRA, since the beneficiary of the IRA is not the spouse; (2) the Decedent's wife is not the beneficiary and therefore cannot withdraw the IRA and roll it over into her own name; and (3) any amounts paid out of the IRA to the Decedent's wife will be taxed to her in the year distributed.

The IRS pointed out that the Decedent's wife is entitled to so much of the income and principal as determined under the ascertainable standard. If the amount so distributed to her exceeds the minimum required distribution for any year, then she, as the surviving spouse of the Decedent, would be entitled to roll such excess over into her own IRA.

PLR 201011036 (Dec. 14, 2009)

In this Private Letter Ruling request, the IRS held that the 10% early distribution penalty would not apply to taxpayer's withdrawals from his IRA because of taxpayer's disability.

Taxpayer was diagnosed with multiple sclerosis, which forced taxpayer to stop working and apply for Social Security disability benefits. Taxpayer was under age 59-1/2 and wanted to withdraw amounts from his IRA before attaining that age. A ruling was requested that the 10% early distribution penalty did not apply because of taxpayer's disability. (This ruling was requested because there is no specific definition of disabled under the applicable tax provisions.)

In general, the 10% early distribution penalty does not apply to distributions attributable to an employee being disabled within the meaning of IRC § 72(m)(7). That section provides that an individual shall be considered to be disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determined physical or mental impairment which can be expected to result in death or to be of long continued and indefinite duration.

Here, taxpayer demonstrated that he has multiple sclerosis and is unable to engage in any substantial gainful activity by reason of this physical impairment. Based on the documentation submitted, the IRS determined that the taxpayer is not expected to recover from this physical impairment in the foreseeable future. Accordingly, the IRS concluded that the taxpayer could make withdrawals from his IRA without being subject to the 10% early distribution penalty.

Cases Involving Charitable Deductions

Federal District Court Finds Promoter of "Aegis" System of "Trusts" Guilty of Conspiracy to Defraud and Aiding the Filing of a False Tax Return – *United States v. Wasson*, C. Dist. Ill., No. 2:06-CR-20055 (December 4, 2009)

The defendant in *Wasson* was found guilty of conspiracy to defraud and of aiding in the filing of a false tax return. The defendant was a promoter of a system of "trusts" marketed under the name "Aegis." The scheme was designed to assign income to trusts and omit the assigned income from the taxpayers' individual income tax returns. The defendant also promoted so-called "charitable trusts" that actually failed to donate anything to charity or to be structured in accordance with federal tax law regarding charitable trusts. From 1994 until 2002, the defendant promoted this sham trust structure to assist taxpayers in fraudulently concealing over $17 million in income. Despite arguing that he acted in good faith belief, the defendant was convicted of conspiracy to defraud and aiding the filing of a false tax return.

Although these schemes are nothing new, they highlight an ongoing concern that some well-intentioned individuals may fall prey to these too-good-to-be true schemes. Some telling signs include schemes that have half-truths, often mixed with a touch of good law, packaged into a bigger sham transaction. Notwithstanding these half-truths, the promises are often – if not always — inconsistent with basic principles of taxation.

The Tax Court Disallows Charitable Deductions and Imposes Accuracy-Related Penalties for Failure To Substantiate Equipment Donations

The Tax Court disallowed a couple's charitable deductions and imposed accuracy-related penalties after finding they did not properly substantiate the contributions or provide contemporaneous written acknowledgements of their medical equipment donations. The couple failed to comply with the strict substantiation requirements because they: (1) did not provide adequate descriptions of the equipment and (2) did not identify the valuation methods used, the manner of acquisition, or the cost basis of the equipment.

On their 2001 and 2002 returns, the Friedmans claimed $217,500 in noncash charitable deductions for donations of diagnostic and laboratory equipment to two charitable organizations. Their tax returns included Forms 8283 and appraisals of only certain items.

For any noncash contribution exceeding $5,000, the regulations require the donor to: (1) obtain a qualified appraisal, (2) attach a fully completed appraisal summary (Form 8283), and (3) maintain records pertaining to the claimed deduction. A qualified appraisal must include: (a) a sufficiently detailed description of the property, (b) the valuation method used to determine fair market value, and (c) the specific basis for the valuation. Further, a qualified appraisal must be made no earlier than 60 days before the date of the contribution and no later than the date of the return, including extensions. The appraisal summary must include: (i) a sufficiently detailed description of the property, (ii) the manner of acquisition, and (iii) the cost or other basis of the property. In addition, a taxpayer must obtain a contemporaneous written acknowledgement from the donee organization.

The Friedmans argued that they "substantially complied" with the regulations. While the Tax Court acknowledged that the regulations are "directory" and therefore only require substantial compliance, and not absolute adherence, the court held that the donors did not substantially comply with the regulatory procedures.

Further, the Friedmans argued that they should be excused from penalties because they relied on the advice of their C.P.A. However, a taxpayer relying on professional advice must show: (1) the adviser was a competent professional, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment. In this case, the Tax Court found the donors liable for the penalties because they did not provide full and accurate information to their C.P.A. and therefore they could not have relied *in good faith* on his advice.

The ultimate lesson of this case is simple: strict compliance with both the letter and spirit of the law is essential. Obtain a qualified and timely appraisal; ensure the appraisal contains all the proper elements; attach a fully completed appraisal summary; maintain meticulous records; and obtain a contemporaneous written acknowledgement from the donee.

Foreign Accounts

IRS Announces Notice and Proposed Regulations Regarding Form TD F 90.22-1 Report of Foreign Bank and Financial Accounts (the FBAR) – *Notice 2010-23; Proposed Regulation 31 CFR Part 103* (February 26, 2010)

The IRS has recently announced further guidance in the area of reporting non-U.S. bank and financial accounts. Most notable among the Proposed Regulations is an attempt to define a "financial account." Additionally, the Notice announced that interests in hedge funds and private equity funds held in tax years 2009 and earlier do not have to be reported on the FBAR.

For more information, see Proskauer Client Alert, "The Foreign Bank and Financial Account Reporting Saga Continues: Further Relief for Prospective Filers," March 5. 2010, available at http://www.proskauer.com/publications/client-alerts/the-foreign-bank-and-financial-account-reporting-saga-continues/

Trust Issues

IRS Extends Interim Relief to Trusts and Estates on Investment Advisory Costs - *Notice 2010-32*

The IRS recently issued Notice 2010-32, which extends for another year interim relief for trusts and estates on the treatment of investment advisory costs subject to the 2% floor under §67(a), so that taxpayers will not be required to determine the portion of a bundled fiduciary fee that is subject to the 2% floor for any taxable year beginning before January 1, 2010. Instead, taxpayers may deduct the full amount of the bundled fiduciary fee without regard to the 2% floor.

Adams v. Comm'r, T.C. Memo 2010-72 (April 13, 2010).

In this case, the Tax Court held that a beneficiary was permitted to claim a mortgage interest deduction for trust property.

Title to certain real property was transferred to a grantor trust for a 5-year period. Petitioner held a beneficial interest in that trust. Petitioner lived in the property held by the trust and paid the principal and interest on the loans secured by the property. Petitioner claimed mortgage interest deductions that the IRS disallowed.

In general, interest on a mortgage is deductible if the indebtedness is an obligation of the taxpayer and not an obligation of another. However, if the taxpayer is not directly liable on the mortgage, the mortgage interest paid by the taxpayer may still be deductible if the taxpayer is the legal or equitable owner of the property. Whether or not the taxpayer is the legal or equitable owner of property is a fact based inquiry and depends on certain factors (e.g., whether the taxpayer has the right to possess the property and to enjoy its use, rents and profits; whether the taxpayer has the duty to maintain and the right to improve the property).

Based on the facts presented, the Tax Court determined that the beneficiary was the equitable owner of the property and had assumed the benefits and burdens of its ownership. Specifically, (i) the beneficiary had a duty to maintain and repair the property; (ii) the beneficiary paid the taxes attributable to the property; and (iii) the beneficiary had a right of first refusal to purchase the property. Therefore, the Tax Court concluded that the beneficiary was entitled to claim the mortgage interest deduction.

Spendthrift Provision of Trust Not Invalidated Despite Control by Beneficiary

In *Miller v. Kresser*, --- So.3d ---, 2010 WL 1779899 (Fla. 4th DCA May 5, 2010), the Florida Court of Appeal, Fourth District, ruled that a creditor cannot invalidate a trust's spendthrift provision to reach the trust assets so long as the language of the trust agreement meets statutory requirements.

In 2004, a fully discretionary trust was established for the beneficiary by his mother, and the beneficiary's brother was appointed as the trustee. The trust agreement contained both a spendthrift provision and a provision stating that the trustee had full discretion to determine the timing and amount of all distributions.

In 2007, a creditor obtained a judgment against the beneficiary, individually. The creditor was unable to collect on his judgment from the beneficiary, individually, so he sued to invalidate the trust.

During the trial it was shown that the trustee had completely turned over management of the trust's operations, including investment decisions, to the beneficiary. The trustee never independently investigated these decisions to determine if they were in the trust's best interests and merely rubber-stamped the beneficiary's decisions.

Despite those facts, the court held that Florida law requires the focus to be on the terms of the trust and not on the actions of the trustee or the beneficiary. While the court agreed that the facts were an egregious example of a trustee abdicating his responsibilities, the trust agreement grants the trustee the sole authority to manage and distribute the trust property. Florida law provides that with a fully discretionary trust, a creditor may only reach those distributions which the trustee chooses to make and that this law applies whether or not the trustee has abused his discretion in managing the trust. Furthermore, there is no law in Florida allowing a creditor to reach trust assets simply because the trustee allowed the beneficiary to exercise significant control over the trust.

NYS Department of Tax Rulings and other New York Issues

Petition No. M090929A, NYS Dep't of Taxation & Finance Advisory Opinion, TSB-A-10(1)(M)

In this Advisory Opinion, New York State determined that a non-resident decedent's interest in a revocable trust that owned interests in several limited liability companies ("LLCs") that held New York real property was not subject to New York State estate tax.

The decedent was domiciled in and a resident of Florida. Through his revocable trust, the decedent owned various minority interests in several LLCs (classified as partnerships for Federal income tax purposes) organized under the laws of New York State. The LLCs held commercial and residential property located in New York. The business purpose of the LLCs is to rent these properties to tenants for a profit. The decedent never resided in or personally owned any of the properties. The decedent never participated in the management of the LLCs (the decedent was a limited partner) and did not provide any of services to the LLCs.

In general, a non-resident decedent's intangible property is not subject to New York State estate tax. (New York State estate tax is imposed on real or personal property owned by a non-resident decedent located in the State.) Because the LLCs are multi-member LLCs that elected to be treated as partnerships for Federal income tax purposes, the LLCs are considered to be separate from its owner. Thus, New York State concluded that the revocable trust's interest in the LLCs constituted an intangible asset that was not subject to New York State estate tax.

Mid-Year Replacement of Trustees May Render a New York Resident Trust Immediately Non-Taxable by New York State

Under New York law, a New York resident trust (such as any testamentary trust created by a decedent who was domiciled in New York at his or her death) is not taxable in New York as long as three conditions are satisfied: (1) none of the Trustees are domiciled in New York, (2) all of the assets of the trust are located outside of New York and (3) the trust has no New York sources of income.

Until recently, it was uncertain whether a mid-year change in the taxable status of a New York resident trust (such as by replacing all Trustees domiciled in New York with

Trustees domiciled elsewhere) would take effect immediately, or whether the entire taxable year would be "tainted" by that portion of the year in which the trust was taxable in New York; just as one dollar of New York source income renders the entire income of the trust taxable in New York, the fear was that a single day as a taxable trust rendered the trust taxable in New York for the entire year.

Happily, in June the New York Department of Taxation and Finance issued Advisory Opinion No. TSB-A-10(4)I (June 8, 2010), which clarifies that a New York resident trust is non-taxable by New York immediately upon satisfying the three conditions listed at the beginning of this article. As such, in the year of the change in taxable status, New York will only tax income accrued prior to the trust's becoming non-taxable by New York State.

However, even if a resident trust is non-taxable in New York for the entirety of the tax year (and thus no New York tax is due), another recent publication of the New York Department of Taxation and Finance, Memorandum TSB-M-10(5)I (July 23, 2010), clarifies that the trust must still file a New York State fiduciary income tax return if the trust is required to file a federal income tax return. The New York return must include with it Form IT-205-C, *New York State Resident Trust Nontaxable Certification*, wherein the Trustees affirm that the trust is not taxable by New York State.

Retroactive Amendments to New York Power of Attorney Law

After much outcry from the Bar, the New York legislature passed, and, on August 15, 2010 Governor Patterson signed, amendments to the New York Power of Attorney Law in which a new statutory form and framework were implemented effective September 1, 2009.

The motive for the 2009 change was the perceived abuse of powers of attorney by the appointed agents. However, the cure for that concern carried with it a new set of problems. Among other things, the 2009 law required that all powers of attorney executed in New York include a verbatim recitation of a cautionary statement and an agent notice related to the powers given to, and responsibilities of, appointed agents. The law also provided that any existing power of attorney automatically would be revoked by the execution of a new power of attorney.

What engendered opposition to the 2009 law was the extraordinarily broad range of instruments that fell under its rubric. In particular, the definition of a power of attorney subject to the 2009 law includes *any* written instrument signed in New York in which someone appoints an agent to act on his or her behalf. Thus, before the 2010 amendments, common commercial and business documents in which an individual grants an agent the power to act on his or her behalf, such as stock powers, voting proxies and limited liability company agreements, were not be valid if they are not in compliance with the 2009 law.

The 2010 amendments, which will become effective on September 13, 2010 and apply retroactively to powers of attorney executed on or after September 1, 2009, narrow the definition of a power of attorney by specifying that the law will not apply to:

> 1. a power of attorney given primarily for a business or commercial purpose, including without limitation:

(a) a power to the extent it is coupled with an interest in the subject of the power;

(b) a power given to or for the benefit of a creditor in connection with a loan or other credit transaction;

(c) a power given to facilitate transfer or disposition of one or more specific stocks, bonds or other assets, whether real, personal, tangible or intangible;

> 2. a proxy or other delegation to exercise voting rights or management rights with respect to an entity;

> 3. a power created on a form prescribed by a government or governmental subdivision, agency or instrumentality for a governmental purpose;

> 4. a power authorizing a third party to prepare, execute, deliver, submit and/or file a document or instrument with a government or governmental subdivision, agency or instrumentality or other third party;

> 5. a power authorizing a financial institution or employee of a financial institution to take action relating to an account in which the financial institution holds cash, securities, commodities or other financial assets on behalf of the person giving the power;

> 6. a power given by an individual who is or is seeking to become a director, officer, shareholder, employee, partner, limited partner, member, unit owner or manager of a corporation, partnership, limited liability company, condominium or other legal or commercial entity in his or her capacity as such;

> 7. a power contained in a partnership agreement, limited liability company operating agreement, declaration of trust, declaration of condominium, condominium bylaws, condominium offering plan or other agreement or instrument governing the internal affairs of an entity authorizing a director, officer, shareholder, employee, partner, limited partner, member, unit owner, manager or other person to take lawful action relating to such entity;

> 8. a power given to a condominium managing agent to take action in connection with the use, management and operation of a condominium unit;

> 9. a power given to a licensed real estate broker to take action in connection with a listing of real property, mortgage loan, lease or management agreement;

> 10. a power authorizing acceptance of service of process on behalf of the principal; and

> 11. a power created pursuant to authorization provided by a federal or state statute, other than this title, that specifically contemplates creation of the power, including without limitation a power to make health care decisions or decisions involving the disposition of remains."

In addition, previously executed powers of attorney will no longer automatically be deemed to have been revoked by the execution of new ones. New powers of attorney must explicitly state that the principal intends to revoke pre-existing powers of attorney.

The 2009 law also introduced a new Statutory Major Gifts Rider that principals must sign if they want to grant their agents the power to make gifts in excess of $500 per year. The Bar has voiced many objections to that rider (now renamed the Statutory Gifts Rider) as well. The Law Review Commission is reviewing the related issues and will be issuing preliminary and final reports of its findings on September 1, 2010 and January 1, 2012, respectively.

Finally, under the 2009 law, there existed some uncertainty as to whether a power of attorney executed in another jurisdiction in compliance with that jurisdiction's law would be deemed valid. The 2010 amendments make it clear that it will be, as will a foreign power of attorney executed in New York in accordance with the foreign jurisdiction's law.

New York Court of Appeals Finds that Legal Fees Incurred by Fiduciaries in the Defense of Actions Related to an Estate or Trust are to be Equitably Allocated Among Beneficiaries

In *Matter of Hyde*, 2010 NY Slip Op 05676 (June 29, 2010), the New York Court of Appeals held that New York Surrogate's Court Procedure Act ("SCPA") Section 2110 "grants the trial court discretion to allocate responsibility for payment of a fiduciary's attorney's fees for which the estate is obligated to pay either from the estate as a whole or from shares of individual estate beneficiaries." The Court's holding overruled its 1971 statutory construction in *Matter of Dillon* (28 NY2d 597) (1971) which led to a customary charge of such fees against the entire estate.

The *Hyde* case was brought before the court as a result of objections filed by certain, but not all, of the beneficiaries to trust accountings. The Surrogate's Court dismissed all objections and determined that *Dillon* required that the non-objecting beneficiaries, who had not even stood to gain from the success of the accounting objections, were responsible for over $700,000 in legal fees. Those beneficiaries filed an appeal of the decision which was affirmed by the Appellate Division.

SCPA Section 2210 (2) provides that attorney's fees incurred by a fiduciary in the execution of his or her fiduciary duties can, by court direction, "be paid from the estate generally or from the funds in the hands of the fiduciary belonging to any legatee, divisee, distributee or person interested." The Court of Appeals stated that the *Dillon* decision, in which SCPA 2110 was interpreted as requiring that the entire estate be charged with legal fees "seems to have ignored the plain meaning of the statute . . . . [and] did not focus on considerations of fairness . . . ."

The Court then found that the trial court should engage in a multi-factored assessment of the facts that includes considerations of "1) whether the objecting beneficiary acted solely in his or her own interest or in the common interest of the estate; 2) the possible benefits to individual beneficiaries from the outcome of the underlying proceeding; 3) the extent of an individual beneficiary's participation in the proceeding; 4) the good or bad faith of the objecting beneficiary; 5) whether there was a justifiable doubt regarding the fiduciary's conduct; 6) the portions of interest in the estate held by the non-objecting beneficiaries relative to the objecting beneficiaries; and 7) the future interests that could be affected by reallocation of fees to individual beneficiaries instead of to the corpus of the estate generally . . ."

The Court remitted the case to the trial court for that purpose.

California Income Tax Issues

IRS Requires California Domestic Partners to Split Community Income Between Themselves on Their Individual Federal Income Tax Returns

Since 1999, California has allowed same-sex couples to register as domestic partners and receive many of the legal privileges granted to married couples. However, the California Domestic Partner Rights and Responsibilities Act of 2003 (the "Domestic

Partner Act"), instructed registered domestic partners to use the same filing status on their state income tax returns as they had used on their federal returns. Since federal law prohibits same-sex partners from filing as "married" on their individual federal income tax returns, domestic partners thus could not file as "married" on their individual California state tax returns (note that the Defense of Marriage Act prevents same-sex couples from filing *joint* federal returns).

This meant that domestic partners were at a tax disadvantage, since they could not allocate their community income equally between themselves, which might have decreased their total tax due by lowering the applicable tax bracket of the higher-earning partner.

In 2006, the Chief Counsel of the IRS issued an Advice concluding that since it was not the "inveterate policy" of California to treat domestic partnership like marriage (since domestic partners did not have the same community property rights as a married couple), domestic partners could not apportion their community income equally between themselves.

Shortly thereafter, California amended the Domestic Partner Act so as to no longer prohibit domestic partners from filing as "married" on their individual returns. As a result, on May 8th the Chief Counsel issued Advice Number 201021050, which concludes that since California now treats domestic partners equivalent to married couples for community property purposes, domestic partners must now divide their community income between themselves on their individual tax returns. Domestic partners may, but are not required, to amend their 2007 through 2009 returns to comply with this ruling.

Florida Issues

New Florida Statute Affirms that Inter Vivos QTIPS are Not Self-Settled Trusts

The Florida legislature has amended § 736.0505 of the Florida Trust Code, effective July 1st, to explicitly state that an inter vivos qualified terminal interest property ("QTIP") trust will not be considered a self-settled trust, even if the trust agreement provides that assets are to be held in further trust for the benefit of the Settlor if he or she survives his or her spouse.

An inter vivos QTIP trust is often used to allow a richer spouse to pass assets to the poorer spouse so that each spouse can take maximum advantage of their respective estate tax exclusion amount. As long as the transfer is not fraudulent, the inter vivos QTIP trust's assets are not reachable by the Settlor's spouse's creditors. Such trusts are particularly useful in second marriages, since they allow the Settlor to designate his or her children from a previous marriage as the ultimate beneficiaries of the trust's assets.

Often, inter vivos QTIP trusts provide that, in the event the Settlor survives his or her spouse, the trust's assets are to be held in further trust for the benefit of the Settlor. Such an arrangement allows the Settlor to have his or her cake and eat it too, since assets equal to the estate tax exclusion amount pass estate tax-free at the spouse's death, but remain available for the Settlor's support during his or her lifetime.

Prior to this change in law, the possibility existed that Florida (like several other states) would treat such an inter vivos QTIP trust as a self-settled trust, thereby placing its assets within reach of the Settlor's creditors. This, in turn, raised the possibility that the trust would be included in the Settlor's estate by virtue of the creditors' constructive power of appointment.

By confirming that an inter vivos QTIP trust will not be considered self-settled in these circumstances, and that the assets of the trust will only be includable in the estate of the Settlor's spouse, the legislature has sanctioned the use of a valuable mechanism for "equalizing" assets between spouses for purposes of the estate tax exclusion amount.

Florida Legislature Grants Courts the Broad Power to Construe Wills and Trusts in the Absence of a Federal Estate Tax

The Florida legislature has amended § 733.1051 of the Florida Probate Code and § 736.04114 of the Florida Trust Code to grant Florida courts broad authority to determine and effect the Testator/Settlor's probable intent in employing a formula bequest, in the event such bequest does not function correctly due to the lack of a federal estate or generation-skipping transfer ("GST") tax in 2010.

The statutes allow the court to consider "the terms and purposes" of the document, the "facts and circumstances" surrounding its creation and the Testator/Settlor's probable intent. In the course of this analysis, the court is allowed to consider evidence relevant to intent, "even though the evidence contradicts an apparent plain meaning of the trust instrument."

The legislatures of other states, such as Virginia and Utah, have handled the unexpected (if not unforeseen) elimination of the federal estate tax in 2010 by construing formula bequests as if the 2009 federal tax laws were still in effect. For instance, if the Will of a decedent dying in 2010 creates a credit shelter trust, these states would direct that the trust be funded with the remaining portion of the Testator's ersatz $3.5 million exclusion amount (i.e., the exclusion amount in effect in 2009).

The Florida statutes, by comparison, give the court greater flexibility to fashion a construction that takes into account both the tax law as it stands in 2010 and the tax law as the Testator expected it to be. For instance, in accordance with the statute, the court, rather than being locked into using a $3.5 million exemption amount, could choose to fund the credit shelter trust with $1.3 million of general property subject to the aggregate basis increase under § 1022(b) of the Code, and then place $3 million of spousal property subject to the aggregate basis increase under § 1022(c) of the Code into a separate marital trust for the surviving spouse.

The Florida statutes do not apply if the Will or trust explicitly provides for the possibility that no federal estate or GST tax is in effect.

Florida Enacts New Florida Statutes Section 736.0902, Nonapplication of Prudent Investor Rule, that Limits Duties and Liabilities of Trustees with Respect to Life Insurance

Florida has enacted a new statute that virtually eliminates trustee liability with respect to (1) insurable interest issues related to the ownership of life insurance and (2) investing in life insurance policies.

Under the Nonapplication of Prudent Investor Rule, a trustee will have no duty to ensure that there exists an insurable interest in a life insurance policy if:

- 1. the trust owns insurance on the life a “qualified person” which is a new statutory concept defined as the “insured or a proposed insured, or the spouse of that person, who has provided the trustee with funds used to acquire or pay premiums with respect to a policy of insurance” on the life of any of those individuals;
- 2. the trust agreement does not opt out of the application of statute;
- 3. the insurance policy is not purchased from a trustee affiliate nor will the trustee or any trustee affiliate receive commissions related to the policy purchase unless trustee investment duties were delegated to another person;
- 4. the trustees did not know that the beneficiaries lacked an insurable interest when the policy was purchased; and
- 5. the trustee did not have knowledge of a STOLI (stranger-owned life insurance) arrangement.

Moreover, under the new statute, a trustee has no duty to determine whether the life insurance policy is a proper investment, to diversify with respect to any policy, to investigate the financial strength of the issuing company, to decide whether to exercise any policy options nor to examine the financial and physical health of the insured if the first three criteria above apply and either:

- 1. the trust agreement affirmatively opts in to the application of the statute or
- 2. the trustee gives notice to the trust beneficiaries of the trustee’s intention to opt in to the statute, and no beneficiary objects within 30 days of receipt of that notice or any written objections are withdrawn.

The statute is effective July 1, 2010, as of which date Florida joins Delaware, West Virginia, North Dakota, Wyoming, South Carolina, Pennsylvania, and, to a limited extent Alabama in providing such trustee protections.

Changes in Florida Homestead Laws

Under Florida law, a “homestead” enjoys certain protections. A homestead is, generally, the home and land on which an owner and his or her family reside. The Florida Constitution exempts homesteads from most liens and judgments, which protection inures to the surviving spouse or heirs of the owner.

The Constitution prohibits an owner from “devising” a homestead if the owner is survived by a spouse or minor child (unless the owner is not survived by any minor children and devises the homestead to his or her spouse). Florida probate rules define “devise” and mandate certain dispositions if a homestead is devised inconsistently with the Constitution. A devise is a testamentary disposition of the property. A homestead devised contrary to the Constitution is void. Under prior law, if a decedent was survived by a spouse and descendants, property which was devised improperly passed instead to the surviving spouse for life with a vested remainder in the living descendants.

The new rules allow a homestead owner to transfer the property during his or her lifetime, with certain conditions, and be free from the Constitutional restrictions. The primary condition is that the owner cannot retain the power to revoke the transfer or revest the interest in himself or herself. The owner may retain extensive rights and impose substantial limitations on the rights of the donees without violating this condition.

The owner may, for example, change the rights of beneficiaries within a certain class as long as the owner cannot exercise the right in favor of himself or herself, his or her creditors, or to discharge his or her legal obligations. The transferor may also retain a separate interest in the property such as a life estate, reversion, etc. Moreover, the donees may possess the property only upon a certain date or specified event, such as the transferor's death. The interest may also be subject to divestment upon a certain date or specified event.

Another major change is that the surviving spouse may now choose to be a tenant in common with the decedent's living issue instead of possessing a life estate. This may help surviving spouses because the law for tenancy in common is clearer for purposes of valuation, allocation of ownership expenses, and division of sale proceeds than that of life estates. It also allows the spouse to use partition procedures – which is not permitted with a life estate.

Florida Supreme Court Limits Charging Order Protection of Florida LLCs

The Florida Supreme Court has issued its opinion in the case of *Olmstead v. Fed. Trade Comm'n*, No. SC08-1009 (Fla. June 24, 2010), holding that a court may order an owner of a single-member Florida Limited Liability Company ("LLC") to surrender its ownership interest in the LLC to satisfy an outstanding judgment. The Court's holding clarifies that charging orders are not the exclusive remedy to enforce a judgment against the member of a single-member Florida LLC. Additionally, the holding creates uncertainty regarding the benefits provided by multimember LLCs formed in Florida and jeopardizes the level of asset protection provided by such LLCs.

This opinion is of note even to non-Floridians, since it acts as a reminder that LLCs, which were originally conceived to limit the liability of business owners, may not be the best option for clients looking for a personal asset protection strategy.

Prior to this ruling, it was not clear under the Florida Limited Liability Company Act (the "LLC Act") whether a charging order was the exclusive remedy available for judgment creditors with respect to a single-member Florida LLC. A "charging order" is a legal remedy that provides judgment holders with the limited right to receive distributions (if any) made by an LLC to its members, but which does not allow a judgment holder to seize the debtor's entire ownership interest. In *Olmstead*, the Court held that a charging order is not the exclusive remedy available to creditors, and that therefore an individual's ownership interest in a single-member Florida LLC (i.e., the right to receive distributions and to manage the LLC) may be subject to levy and sale to a third-party to pay the judgment.

The Court's analysis focused on the charging order provision of the LLC Act, which provides that a court may charge a member's LLC membership interest for payment of a creditor's judgment lien. The question decided by the Court was whether the charging order provision provides the exclusive remedy with respect to a judgment debtor's ownership interest in a single-member Florida LLC. The Court concluded that the charging order is a "non-exclusive remedy" because there is no express language in the statute providing that it is the exclusive remedy to satisfy a judgment lien, unlike the Florida Revised Uniform Partnership Act ("Partnership Act") and the Florida Revised Uniform Limited Partnership Act ("LP Act"), both of which specifically state that charging orders are "exclusive remedies" for enforcement of judgment liens.

In addition to subjecting single-member Florida LLC interests to actual levy and sale, this case appears to threaten the degree of protection provided by "multimember" Florida LLCs, since the provisions of the charging order statute apply to single-member as well as multimember Florida LLCs. As a result, the *Olmstead* decision threatens multimember Florida LLCs in two ways: first, owners of LLC membership interests may find their holdings subject to levy and sale to satisfy a judgment lien (rather than merely being subjected to a charging order to pay over LLC distributions), and second, other members of the LLC may find that a judgment creditor of one of the members has quite unexpectedly become the newest (and likely unwanted) member of the LLC, with the right to fully participate in its management and operation.

The Personal Planning Department at Proskauer is one of the largest private wealth management teams in the country and works with high net-worth individuals and families to design customized estate and wealth transfer plans, and with individuals and institutions to assist in the administration of trusts and estates.

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