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Sponsor:	SECURITY NATIONAL BANK OF SIOUX CITY
Start Date:	10/26/2017
End Date:	10/26/2017
City:	South Sioux City
Class Type:	Standard(live)
Total CLE Hours Approved:	4.0
Ethics Hours Approved:	1.0
Activity Number:	271738

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Security National Bank

2017 Estate Planning Seminar

Thursday, October 26, 2017

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The McGuireWoods Private Wealth Services Group

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The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about these seminar materials. Please feel free to contact any member of the Group.

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PART A

Planning in a Time of Uncertainty

Planning in a Time of Uncertainty

I. Introduction

A. Definition of Estate Planning

Estate Planning is the act of preparing for the transfer of a person's wealth and assets after his or her death. Assets, life insurance, pensions, real estate, cars, personal belongings, and debts are all part of one's estate.[1] Please note that this definition does not mention tax planning.

[1] www.investinganswers.com

B. Impact of 2016 Federal Election

1. The most conspicuous development of 2016, affecting many areas of public policy including tax policy, is clearly the 2016 election, most notably the election of President Donald Trump and the retention of Republican control of the Senate. With the continued Republican control of the House, the Republicans have complete control of the executive and legislative branches of the federal government and the ability to implement the tax law changes that they would like (if they can agree).

2. While tax reform is discussed almost every four years, and it is harder to do than it sometimes sounds, the talk this year is serious. With control of both Houses of Congress barely changed and the surprising capture of the White House, Republican leadership will be under enormous pressure to produce very significant tax legislation in 2017 by the August recess because now they can, and because, with no excuses left, they must. The June 2016 Blueprint summarized below, which Ways and Means Chairman Kevin Brady has described as 80 percent in sync with President Trump's campaign's plan and to which the President's transition team had seemed largely willing to defer, may be the likely vehicle. However on April 26, 2017, President Trump introduced his "2017 Tax Reform for Economic Growth and American Jobs." This was a one page outline of broad tax proposals for both individual and corporate tax reforms.

C. History of Estate Tax

1. The United States has had estate or inheritance taxes four times in its history starting almost in the infancy of the Republic.

2. The Stamp Act of 1797 imposed a federal stamp on wills in probate to pay off debts incurred during the undeclared naval war with France in 1797. Congress repealed the Stamp Act in 1804.

3. The Tax Act of 1862 imposed a federal inheritance tax. Congress increased the rates and added a succession tax in 1864. The tax was repealed in 1870.

4. The War Revenue Act of 1898 to help pay for the costs of the Spanish-American War imposed a tax, but was repealed shortly after enactment.

5. The modern estate tax was enacted in 1916 and continues to be in effect today although it has been greatly modified and changed since its enactment. The gift tax was enacted in 1924 but really became effective in 1932 and the generation-skipping transfer tax was enacted in 1976 and dramatically altered in 1986.

D. Current Estate Tax Laws and Impact on Individuals

1. The federal government and the state where an individual resides or owns real estate can impose taxes on the transfer of wealth during life or at death. The three federal taxes are:

   a. The estate tax (for transfers at death);

   b. The gift tax (for lifetime transfers); and

   c. The generation-skipping transfer ("GST") tax (for transfers, during life or at death, to individuals two or more generations below the transferor).

2. The two basic federal taxes are the estate and gift taxes. Generally, one of these taxes is imposed when one person transfers property to another without receiving equal value in return.

3. All property owned by a person at death is subject to the estate tax. The gift tax applies only to specific property items that a person gratuitously transfers during life.

4. The gift tax applies to any direct or indirect transfer of property. This includes outright gifts or gifts in trust, gifts of real property, and gifts of both tangible and intangible personal property. Types of transactions that may be considered gifts include:

   a. The transfer of cash or securities.

   b. The creation of a trust.

   c. The forgiveness of a debt.

   d. An interest-free or below-market interest rate loan.

e. The assignment of a judgment.

f. The assignment of the benefits of an insurance policy.

g. The transfer of an automobile, boat, painting, jewelry, or other personal property.

h. Permitting a child or friend to use a vacation home without paying rent.

5. The transfer must be made for donative, rather than business, purposes. Although an individual may make a taxable gift without being aware of it (such as selling stock in a closely-held business to a son for an amount of money that is later determined to be less than the fair market value of the stock), generally a taxable gift must be accompanied by donative intent on the part of the donor.

6. For this reason, involuntary transfers and most bona fide business transactions fall outside the scope of the gift tax. Transfers made according to divorce decrees and arm's-length business sales that turn out to be windfalls for the purchaser are not taxable gifts.

7. The amount subject to gift tax is the difference between the fair market value of the property transferred and the value of any consideration received in return. The gift tax applies only if there has been a completed, irrevocable transfer of property from one person to another. If the transfer can be revoked by the donor, then no completed gift has occurred. If an individual makes a transfer that is not a taxable gift because at the time of transfer it was not complete and irrevocable, then a taxable gift will occur whenever the transfer does become irrevocable. Thus, if an individual establishes a trust for the benefit of his son and retains the right to revoke the trust, no taxable gift has been made.

8. There are a number of deductions and exclusions that may protect a gratuitous transfer from estate tax or gift tax:

   a. An individual can give up to $14,000 of property each year to a donee free of tax as a so-called "annual exclusion gift." A married couple can each give $14,000 separately to a donee, or one spouse of the couple can give $28,000 to that donee and the other can agree to be treated as having split the gift. There is no limit on the number of annual exclusion gifts that can be made.

   b. An individual may pay for tuition or medical expenses of a donee without incurring gift tax liability. These payments must be made directly to the educational institution or individual care provider.

c. A person can transfer unlimited amounts of property to his or her spouse free of tax because of the unlimited "marital deduction." These transfers must be made outright to the spouse or into certain types of qualifying trusts for the exclusive benefit of the spouse during the spouse's life.

d. Transfers to qualifying charities during life or at death are entirely transfer tax free. There are no limitations on the charitable deduction for estate tax or gift tax purposes.

9. The applicable exclusion amount for each individual was set at $5,000,000 in 2011 for both the estate tax and the gift tax and indexed for inflation starting that year. The applicable exclusion amount as adjusted for inflation is $5,490,000 in 2017. The applicable exclusion amount currently shelters most estates from being subject to the estate tax.

10. The third federal transfer tax is the generation-skipping transfer tax, or "GST tax."

a. The GST tax was designed to fill a gap in the estate and gift tax systems which previously allowed certain transfers to avoid taxation. Before the enactment of the tax in 1986, an individual could avoid transfer taxes on property over many generations by placing the property in a long-term trust for the benefit of several generations of beneficiaries, or by skipping over one or more generations of beneficiaries entirely (for example, by leaving property directly to grandchildren and bypassing children). If the trust was properly structured, the trust property would escape taxation as it passed from generation to generation. Only when the trust terminated would the property be subject to taxation. A trust could last for several generations and insulate property from transfer tax during that time.

b. Now, if an individual makes a transfer of property in a manner which will escape the gift tax or estate tax at a lower generation level, the GST tax may be imposed at a flat rate equal to the highest transfer tax rate (45% in 2009; 35% in 2011 and 2012; and 40% in 2013 and thereafter). There are certain exemptions to the tax, the most important of which is the "GST exemption." The GST exemption in 2017 is $5,490,000.

II. The Possibility of Changes in the Estate Tax

A. Trump's Proposal

1. The Donald J. Trump for President Website had the following text on the website about the estate tax:

"The Trump Plan will repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into a private charity established by the decedent or the decedent's relatives will be disallowed."[2]

2. In September 2016, Candidate Trump said of his proposal, "It ends the death tax. It's a double taxation, a lot of families go through hell over the death tax."

3. It was unclear from the current Trump Proposal whether the gift tax and the generation-skipping transfer tax would be repealed and whether the proposal referred to a capital gains tax on appreciated assets at death or carryover basis in some modified form as was proposed in the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") for one year in 2010 when the estate was to be repealed.

B. Republican Blueprint

1. The Republican leadership of the House of Representatives issued "A 21st Century Tax System Built for Growth" on June 23, 2016 as a "Blueprint" to outline how it wishes to reform the current income tax system. The Blueprint noted upfront that it does not include a value-added tax (VAT), a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system. With the Republican control of the executive and legislative branches, the Blueprint is likely to be a guide for the Republicans as they consider reform of the tax code,

2. According to the Blueprint, the new tax system will simplify and lower tax rates. It also will provide for reduced but progressive tax rates on capital gains, dividends, and interest income. In addition, the changes will significantly reduce the complexity and compliance burdens of the current system.

3. One integral part of this Blueprint is a new IRS that will be aligned with the new tax code. Under the Blueprint, the new IRS will be built for customer service. The new IRS will have a unit that will serve families and individuals and a separate unit that will serve businesses.

4. The Blueprint notes that, at the beginning of the 114th Congress, House Republicans approved a rule requiring the Joint Committee on Taxation to estimate the macroeconomic effects of major tax legislation and to include changes in Federal revenues resulting from changes in the size of the economy to be included as part of the official revenue estimate. This means that dynamic scoring, as opposed to static scoring will be used.

5. The Blueprint assumes that the substantial tax increases enacted as part of the Obamacare law will be repealed.

6. Highlights:

a. This Blueprint seeks to simplify, flatten, and lower tax rates for families and individuals and to provide reduced and progressive tax rates on capital gains, dividends and interest income, to encourage savings and investment. This Blueprint will eliminate the alternative minimum tax. The Blueprint also will eliminate the estate tax and the generation-skipping transfer tax "so that the death of a family member or loved one no longer will be a taxable event.

b. Individual Income Tax Rates.

(1) The Blueprint consolidates the current seven tax brackets to three brackets and lowers the top individual income tax rate to 33 percent. Going forward, these income tax brackets will be indexed for inflation.

INDIVIDUAL INCOME TAX BRACKETS UNDER THE BLUEPRINT

Current Law	Blueprint
10%	0% / 12%*
15%	
25%	25%
28%	
33%	33%
35%	
39.6%	

* The new standard deduction is larger than the current-law standard deduction and personal exemptions combined. This, in effect, creates a larger 0 percent bracket. As a result, taxpayers who are currently in the 10 percent bracket always will pay lower taxes than under current law.

(2) The Blueprint creates a new business tax rate for small businesses that are organized as sole proprietorships or pass-through entities, which means that small business income will be subject to a maximum tax rate of 25 percent.

(3) Individual Alternative Minimum Tax. This Blueprint repeals the individual AMT.

c. Income from Savings and Investment. The Blueprint provides for reduced tax on investment income. Families and individuals will be able to deduct 50 percent of their net capital gains, dividends,

and interest income, leading to basic rates of 6 percent, 12.5 percent, and 16.5 percent on such investment income depending on the individual's tax bracket. The Blueprint also includes interest income within the reduced tax on investment income, as part of the move in the direction of a cash-flow tax.

d. Consolidation of Deductions. The Blueprint consolidates five basic family tax deductions and credits—the basic standard deduction, additional standard deduction, personal exemption for taxpayer and spouse, the personal exemptions for children and dependents, and the child tax credit into one deduction and one credit—a larger standard deduction and an enhanced child and dependent tax credit.

e. Earned Income Tax Credit. The Blueprint will continue the earned income tax credit ("EITC").

f. Simplification of Tax Benefits for Higher Education. This Blueprint will simplify the current array of tax benefits for families looking to make education more affordable for their children by simplifying and consolidating the current-law provisions to provide a package of higher education tax benefits that will cover both college and vocational training programs, including a savings incentive, such as 529 plans, and tax relief targeted at helping low- and middle-income families with the costs of higher education, such as the American Opportunity Tax Credit.

g. Individual Exclusions and Deductions. The Blueprint reflects the elimination of all itemized deductions except the mortgage interest deduction and the charitable contribution deduction.

h. Retirement Savings. The Blueprint appears to continue current incentives for savings such as Individual Retirement Accounts ("IRAs"). It also states that the Committee on Ways and Means will explore the creation of more general savings vehicles, using as a model the existing retirement accounts. It may look at Universal Savings Accounts. These are accounts to which individuals could contribute cash and over which they would have full control of investment decisions. Account holders could withdraw both contributions and earnings at any time, and for any reason, without penalty.

i. Estate and Generation-Skipping Transfer Taxes. This Blueprint repeals the estate and generation-skipping transfer taxes which "will eliminate the Death Tax, which can result in double, and potentially even triple, taxation on small businesses and family

farms." The Blueprint does not mention repealing the gift tax and this omission seems deliberate.

C. Impact on Estate Tax, GST Tax, and Gift Tax. As can be seen above, it is unclear as what form, if any, repeal or changes in the estate, gift, and generation-skipping transfer tax will take. Some questions are:

1. Will all three taxes be repealed?

2. Will the gift tax be retained as it was in the 2001 Tax Act? The reason for the retention of the gift tax in the 2001 Tax Act was to prevent United States citizens from making gifts of highly appreciated assets to family members or others in jurisdictions that have no income tax or gift tax. The recipients would then sell the highly appreciated assets and pay no capital gains or other taxes. Then the recipients would gift the proceeds back to the original United States donors.

3. Will there be a step up in basis for assets passing at a decedent's death?

4. Will a capital gains tax be imposed at death? If so, will there be exemptions or a threshold before the capital gains tax will be imposed?

5. Will there be carryover basis for appreciated assets at death? If so, will there be a modified carryover basis regime as there was in the 2001 Tax Act? Under the 2001 Tax Act, a decedent's executor could allocate a basis increase of up to $1.3 million, regardless of the recipient of the property. An additional $3 million of basis could be allocated to property owned by the decedent at death that was transferred to the decedent's surviving spouse either as an outright gift or as qualified terminable interest property ("QTIP").

D. Statements on Possible Repeal

1. Many commentators made predictions on the future of the estate tax after the election of President Trump.

2. "It will still be a heavy lift but not insurmountable as it has been with Obama in office. Trump made repeal of the death tax a key tenet of his tax reform proposal, and we look forward to working with him to see it through." Palmer Schoening, President of the Family Business Council.

3. "I look forward to working with President-elect Trump on legislation to permanently bury the death tax once and for all. For too long, this tax has threatened family owned businesses—including women and minority-owned businesses—from being passed down to their children and grandchildren. It's time to move forward with pro-growth reform that fully repeals it with a tax code built for growth." Kevin Brady, Chair of the House Ways and Means Committee, November 21, 2016.

4. “The death tax on family farms, small businesses, ranches and estates has crippled hard-working families for far too long. It ought to be repealed, plain and simple.” Orrin Hatch, Chair of the Senate Finance Committee, November 21, 2016.

E. President Trump’s Agenda for Tax Reform

1. On April 26, 2017, the Trump Administration introduced its one-page outline of tax reform proposals which was called the “2017 Tax Reform for Economic Growth and American Jobs.” The administration described the proposal as the “biggest individual and business tax cut in history.”

2. The individual reforms in the Trump proposal are:

   a. Reducing the current seven income tax brackets to three tax brackets of 10%, 25%, and 35%.

   b. Doubling the standard deduction.

   c. Providing tax relief for families with child and dependent care expenses.

   d. Eliminating all deductions except the home mortgage interest deduction and the charitable income tax deduction.

   e. Repealing the 3.8% tax on net investment income.

   f. Repealing the alternative minimum tax

   g. Repealing the death tax.

3. The corporate tax reforms in the Trump proposal are:

   a. 15% business tax rate (which would also apply to income derived from pass-through entities.

   b. Territorial tax system.

   c. One-time tax on trillions of dollars held overseas.

   d. Elimination of tax breaks for special interests.

4. The response to the Trump proposal on Capitol Hill was muted with most Members of Congress who commented saying the proposal would not be the starting point for discussions on tax reform.

F. Legislative Framework

1. It might be assumed that the Republican leadership would want some Democratic votes. After all, they made such a big deal of the enactment of the Affordable Care Act without a single Republican vote. But memories are short. In any event, it is not clear that the Republican leadership would want Democratic votes so much that they would try to get 60 total votes in the Senate to "call the question" on regular legislation. A few bipartisan votes are fine, but not so desirable that the leadership would really want to "negotiate" or to concede much to get them. That leaves the process of "budget reconciliation" as the likely process, especially for a clearly fiscal agenda like tax legislation. But while "reconciliation" famously does not need 60 votes in the Senate, the 60-vote requirement cannot be avoided just be using the label "reconciliation." There must first be a "budget resolution," setting out broad guidelines for the inputs of multiple committees that will be brought together and "reconciled." If that budget resolution is not passed by March, or perhaps April, tax reform will be behind schedule.

2. Budget reconciliation can be used only once a year. It is limited to fiscal matters. And it is limited further by constraints like the impropriety of affecting budget outcomes beyond an arbitrary budget window—most recently ten years. We all remember (or have heard about) the peculiar one-year "repeal" of the estate tax that was enacted in budget reconciliation in 2001. Sunsets are not inevitable. There are workarounds. The Taxpayer Relief Act of 1997 was also enacted through budget reconciliation, with substantial permanent estate tax cuts. But both 1997 and 2001 presented much different fiscal environments. In June 2001, when the 2001 Tax Act was enacted—before 9/11, Afghanistan, and Iraq—budget surpluses of trillions of dollars were forecast for the coming decade. The 2001 Tax Act included only a modest one and one-third trillion dollars of tax cuts! Today the forecasts are only more deficits.

G. Possibility of Repeal

1. Some commentators have said that the estate tax will be repealed by Congress and that it is already dead.

2. Others believe that the estate tax may survive and point out:

   a. The technical paths to permanent repeal of the estate tax are complicated and maybe risky to Republicans (especially to the extent they need Democratic support).

   b. The unexpected surge of disillusioned middle-class voters that propelled President Trump to victory may not be very excited about the estate tax.

c. The attractiveness of repeal even to traditional supporters may be blunted by the prospect of having to keep the gift tax, or having to deal with a scary new capital gain or basis regime, and attempts to "have it all" will cost still more and look still more greedy.

d. Repeal of the estate tax in 2017, permanently or temporarily, would require political capital that the Republican leadership will probably decide to spend elsewhere. A compromise reduction of rates by 5 or 10 percent is possible, and even with high exemptions there might actually be some justification in tax policy for bringing transfer tax and income tax rates closer together. But that too would look expensive and possibly too greedy.[3]

H. As of May 15, 2017, three bills have been introduced in Congress with respect to the estate tax.

1. H.R. 198, the Death Tax Repeal Act of 2017, was introduced by Representative Mac Thornberry (R. Texas) on January 3, 2017 and would repeal the estate, gift, and generation-skipping transfer taxes effective as of the date of enactment.

2. H.R. 451, the Permanently Repeal the Estate Tax Act of 2017, was introduced by Representative Robert Latta (R. Ohio) on January 11, 2017 and would repeal the estate tax only and retain the step-up in basis for appreciated assets at death.

3. H.R. 631, the Death Tax Repeal Act of 2017, was introduced by Representative Kristi Noem (R. South Dakota) and Representative Sanford Bishop (D. Georgia) on January 24, 2017 and would repeal the estate tax and the generation-skipping taxes effective as of the date of enactment. A companion bill, S. 205 was introduced in the Senate by Senator John Thune (R. South Dakota).

I. Issues to Be Addressed in 2017. BNA's Daily Tax Report of December 28, discussed six burning questions on the estate tax. These questions are:

1. Will Repeal Occur?

2. Will There Be a Gift Tax?

3. Capital Gains at Death?

4. Will Basis Step-Up Disappear?

5. Special Rules for Businesses or Farms?

6. Does the Charity "Abuse" Provision Stick?

III. Areas of Estate Planning that Will Continue Even if there is Repeal

A. Estate planning will still be necessary to permit an individual to pass assets to his or her beneficiaries in the form that he or she would like. This could include outright gifts or gifts in trust. One has only to look at the contest over the estate of Prince, who died in 2016 and left no will. Prince's heirs are coming out of the woodwork and crying and fighting over his estate.

1. Primary Objectives

a. An estate plan is a plan for transporting one's wealth. Like any transportation plan, it designates a destination—the persons who will receive the property. It also can provide instructions on how the property may be used. In transportation, minimizing breakage is a goal. Likewise, in an estate plan, minimizing loss of property, to taxes or to waste, is an important goal in establishing a plan to pass property as the client wishes.

b. In order to accomplish these goals, an individual will need to formulate his or her specific objectives and desires about the disposition of his or her property, the use of trusts, and the appointment of fiduciaries. The estate planning professional must assist the individual in this process by explaining the available alternatives, and the impact of tax planning and creditor protection considerations.

2. The Will

a. The starting point for addressing all of the client's testamentary planning objectives is a Will. Historically, it is the traditional means of disposing of one's property at death.

b. Wills tend to take one of the following three forms:

(1) A simple will that leaves the testator's property outright to one or more recipients.

(2) A complex will that uses trusts and involves tax planning.

(3) A pour-over will that disposes of the testator's tangible personal property and then directs the distribution of the balance of the testator's property to a revocable trust created by the testator during life.

c. The specific requirements for a Will are governed by state law. The common requirements are that the person signing the Will (often referred to as the testator or testatrix) must be at least 18 years of age, competent, and free of undue influence. A Will generally must be witnessed, and some states either require that the

testator and witnesses appear before a notary public or make the process for admission of the Will easier if it is notarized.

3. The Revocable Living Trust

a. A revocable living trust is a trust created by an individual during life to hold the individual's assets and over which the individual retains complete control. It can provide several important benefits.

b. The creator, or "settlor", of the trust usually names himself as initial trustee and reserves the right to use the trust property for whatever purposes he wishes. The settlor reserves the power to change the terms of the trust at any time.

c. The trust designates one or more successor trustees and provides a mechanism for naming additional successor trustees if necessary. If the settlor becomes disabled, the designated successor trustee of the trust would manage the trust assets for the settlor's benefit. Without the trust, it would be necessary to have a court appoint a guardian to manage the individual's property if he became disabled. The trust, unlike a person, is immune to disability and provides continuity of management.

d. In addition, the trust typically contains testamentary provisions to provide for the disposition of the settlor's assets after his death. Using a trust for this purpose instead of a will has several advantages.

(1) The use of a revocable living trust protects the settlor's privacy. A will must be filed in the probate court after death and becomes a public document. In contrast, in most states, a trust does not have to be filed with the court, so that the details of the settlor's dispositive scheme remain private.

(2) Any assets that were held in the trust at the time of the settlor's death will be disposed of in accordance with the provisions of the trust and will not be subject to probate administration and public disclosure. The expenses of administering a trust after the settlor's death may be less than the expenses of probating the estate, and the process less time-consuming.

(3) In some states, a trust is harder to challenge than a will, so the settlor's estate plan would be more secure in the event that a beneficiary was dissatisfied with the plan and attempted to challenge it in court.

(4) In most states, a trust is easier to amend than a will. Except in a few states (Florida being one example), witnesses are not required.

(5) While revocable living trusts have all of these practical management advantages, they do not save federal income or estate tax. In addition, they are effective only as to property that the settlor actually transfers to the trust. Therefore, it is necessary to change the title to real estate, bank accounts, investment accounts, and other assets.

4. Durable Power of Attorney

a. A durable power of attorney enables an individual, called the "principal," to designate someone as his agent to handle his financial and personal affairs in the event of disability.

b. The power of attorney supplements the disability protection of a living trust by covering aspects of the principal's financial affairs that a trustee of a trust cannot handle, such as dealing with any assets that are not in the trust, signing tax returns, or taking legal action on behalf of the principal.

c. The power of attorney can permit the agent to transfer property into the principal's living trust where it can be managed by the trustee.

d. The laws of most states provide that a properly drafted and validly executed power of attorney will not terminate on the incapacity of the principal, but will remain in effect until the principal actually is adjudicated a disabled person by a court, or until the power is revoked or otherwise terminated by its terms.

e. Like the living trust, a durable power of attorney also may function as a substitute for a guardianship when the principal no longer can manage his affairs. Even where the principal has not established a living trust, use of a durable power of attorney thus can offer management protection in most events, with minimal cost.

f. There is now a Uniform Power of Attorney Act which, as of 2016, has been adopted in 12 states: Alabama, Arkansas, Colorado, Connecticut, Hawaii, Idaho, Iowa, Maine, Maryland, Montana, Nebraska, Nevada, New Mexico, Ohio, Pennsylvania, South Carolina, Utah, Virginia, Washington, West Virginia, Wisconsin. The hope is that the Uniform Act will increase the acceptance of powers of attorney by third parties, and provide a more consistent set of rules for the agents' duties and rights that will reduce abuses by agents.

g. If it is the principal's wish that the agent have the power to make gifts, that power should be explicitly granted in the instrument. The IRS has attempted to recapture in the decedent's gross estate gifts made by an agent pursuant to a durable power of attorney which did not expressly grant the power to make gifts. See Estate of Casey v. Comm'r, 948 F.2d 895 (10th Cir. 1991); Estate of Ridenour v. Comm'r, 94-2 U.S.T.C. ¶60,180 (4th Cir. 1994) (aff'g T.C. Memo. 1993-41, 65 T.C.M. (CCH) 1850 (1993)); Estate of Goldman v. Comm'r, T.C. Memo. 1996-29, 72 T.C.M. (CCH) 1896 (1996). Although the IRS has obtained mixed results from its challenges of such gifts, it continues to be best to include a specific gift giving power. In most jurisdictions, it remains necessary to include a specific provision in a power of attorney authorizing the agent to make gifts.

5. Health Care Power of Attorney

a. A health care power of attorney permits an individual to designate an agent to make health care decisions in the event of the individual's incapacity. This can include the authority to terminate life-sustaining procedures where the individual has a terminal illness. In some states, the health care power is referred to as a health care directive or health care proxy.

b. Health care powers of attorney often permit an individual to give broad instructions on the use or discontinuance of life support measures. For example, a health care power of attorney often allows the withdrawal of food and water. This can be very important if an individual is permanently comatose, but can be kept alive through the administration of food and water.

c. The agent under a health care power of attorney also can be empowered to make decisions about anatomical gifts.

d. A living will is a legal document in which an individual can set forth his wishes regarding the withdrawal of life-sustaining procedures in the event that he becomes terminally ill.

(1) Before health care powers of attorney, most states permitted individuals to sign a living will as a way of expressing their wishes. Living Wills originally did not allow the designation of a decision-maker.

(2) A health care power is generally considered superior to a living will because it designates someone to make those decisions. In addition, in many states, medical procedures that could not be withheld or withdrawn on the basis of a

living will alone, such as the artificial provision of food and water, could be withdrawn by an agent under a health care power. In some states, the healthcare power is combined with or works in conjunction with a living will directive. In other states, the two can be construed as inconsistent and should not be used together.

6. Codicils and Trust Amendments

a. Even a simple estate plan will need to be changed over time. There will be additions to the individual's family, the individual may acquire new assets to be specially disposed of, or relationships will change that cause the individual to want to remove or add someone in the individual's estate plan. While these changes can be addressed in a new will or restated trust agreement, it is often simpler to amend the existing will with a codicil or prepare an amendment to the trust instrument.

b. A codicil may only change a portion of the will, but it is considered to "republish" the entire will. The will and codicil are treated as expressing the testator's intent as of the date of the codicil.

(1) If there are inaccuracies in the original will, either due to drafting errors or because of changed circumstances since the will was signed, these inaccuracies are in effect ratified by the codicil. Therefore, it is important to reexamine the entire will when preparing a codicil. The will also should be reviewed to ensure that nothing in the codicil is inconsistent with it, an ambiguity that could require a will construction suit.

(2) Because the proper execution of a codicil is a republication of the will, any question of the validity of the original will is eliminated by the proper execution of the codicil. A codicil must be executed with the same formalities necessary for proper execution of a will.

c. A trust grantor cannot unilaterally amend a trust unless he reserved the right to do so in the trust instrument, although the laws of some states provide that a trust is revocable by the grantor unless the trust instrument specifically states that it is irrevocable. Although the legal concept of republishing does not apply to trust amendments, the same approach should be taken of reviewing the entire document when preparing a trust amendment. In addition, a trust amendment should include a clause reaffirming the right of the grantor to amend or revoke the trust instrument, including the

provisions added by the amendment. This eliminates any possibility of a dispute over the validity of later amendments.

B. Benefits of Placing Property in Trust

1. Individuals often believe that they need nothing more than a simple will if their estates are below the applicable exclusion amount and they do not anticipate that federal estate tax will be due at either their death or the death of their spouse. A will that leaves all the assets to the spouse and, upon the spouse's death, divides the assets equally among the children is considered sufficient to protect the family adequately. A closer look points out the risks inherent in such a plan.

2. If an individual leaves even modest amounts of money to a spouse who has never had any experience with financial management and investment decisions, he or she may be placing an unfair burden upon the spouse. This type of burden translates into anxiety instead of security.

   a. The surviving spouse may remarry, and all or a portion of the assets originally intended to go to children may end up in the hands of the new spouse, or children of the second marriage.

   b. Even if the surviving spouse does not remarry, he or she may be put in the position of saying "no" to a child who wishes to use the inherited wealth for a risky new business venture or some speculative investment. Depending upon the relative strengths of the child and surviving spouse, imprudent decisions may be made which could rapidly dissipate the property left for the family.

   c. A surviving spouse who has been insulated from financial matters may, upon receiving an inheritance, simply become overwhelmed by the immediate feeling of wealth and independence and live in a manner that could quickly exhaust the remaining estate.

3. By using trusts to transfer property, either during life or at death, the donor is able to maintain an element of control over the property. The donor can designate under what circumstances and for what purposes a beneficiary will receive that property or its income. Trusts also permit the donor to determine who will manage the property as trustee. Other advantages of trusts include the following:

   a. Retention of property in trust preserves the benefits of the investment and management skills of the trustee.

   b. A trust can protect assets from the claims of third-party creditors of the beneficiary, such as the plaintiff in a lawsuit or a spouse in a failed marriage. Generally, a creditor or litigant cannot gain access to assets set aside in a properly drafted trust by someone other than

the beneficiary. The same is generally true with respect to a divorcing spouse, although state law varies on the degree to which courts can consider the existence of trust assets in determining the division of assets upon divorce.

c. Children who have not fully matured may rapidly dissipate an outright inheritance, whereas a trust can provide for incremental distribution of inheritances.

d. Large outright distributions may spoil children and destroy their incentive to provide for self-support.

4. On the other hand, an overly restrictive trust may prevent an entrepreneurial child from reaching the property and exploit a business opportunity. A well-drafted trust can be flexible enough to allow a capable beneficiary to take advantage of such opportunities.

5. Placing property in trust may grandfather trust assets from future estate tax.

C. Advising on Creditor Protection

1. Basic Creditor Protection

a. Outright Gifts of Property. Outright gifts are a simple way for a client to protect his or her assets from the claims of creditors. Assets that the client gives away are no longer subject to seizure by the client's creditors. However, if the client is insolvent, or would become insolvent by making the gift, there may be consequences under the Fraudulent Conveyance statutes

b. Trusts. Trusts may be the most important regularly used and accepted asset protection tool available. For transfer of property by gift, a trust can be used to alleviate the client's concerns about the beneficiary's imprudent use of the property.

c. Co-Ownership. Different forms of co-ownership, such tenancy by the entirety, joint tenancy with right of survivorship, and tenancy in common, may provide some protection against creditors.

d. Trusts for Disabled Beneficiaries.

(1) The most likely potential creditor of a disabled beneficiary is the federal, state or local agency that provides public assistance to that beneficiary. Over the past 10 to 15 years, public agencies have become more aggressive in seeking reimbursement for the cost of caring for disabled persons. Many states have passed laws that permit agencies to seek

reimbursement and that define the assets which are available to the government agency. These statutes must be considered carefully when drafting a trust that is designed to provide supplemental benefits to a disabled person in order to improve the quality of the person's life without having the entire trust subject to confiscation by a government agency.

(2) State case law is not consistent in defining the standard of distribution that will cause trust assets to be chargeable for a disabled beneficiary's care. In many states, a trust that allows the trustee to make distributions for the "support and maintenance" of a beneficiary will be treated as an asset of the beneficiary for the purpose of determining eligibility for public aid. However, in other cases, a state has been unable to obtain reimbursement for public aid where the trust instrument allowed the trustee to use principal for the beneficiary's support and maintenance (especially in cases in which the trust instrument evidenced the testator's intent that trust assets merely supplement support from other sources). Many state legislatures are now attempting to provide statutory guidelines for when trust assets will be considered available to the beneficiary for the purpose of qualifying the beneficiary for public assistance or allowing the state to seek reimbursement from trust assets.

e. <u>Exempt Assets</u>. Separate and apart from the protection of a tenancy by the entirety arrangement, most states have a homestead exemption that allows an individual to always retain a certain amount of equity in their residence. In many states, the exemption is limited; for example, in Illinois, it is $7,500. Florida and Texas, however, have homestead exemptions that allow residents to retain all the equity in their home and adjacent land, subject to certain size (but not value) limitations.

(1) Florida allows a homestead exemption for properties of up to 160 acres outside a municipality, and up to one-half acre inside a municipality.

(2) Texas has a rural homestead exemption for up to 200 acres for a family, 100 acres for a single person; and an urban homestead exemption for up to one acre.

f. <u>Life Insurance</u>. Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, like Illinois, the exemption is available only if the insurance is payable to a member of the immediate family or other

dependent. Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract. Thus, an individual can use an investment-oriented insurance policy as an alternative to transferring property in trust.

g. Retirement Plans. Both ERISA and the laws of many states protect qualified retirement plans from creditors. Individual retirement accounts are not subject to the ERISA protections, but are protected under the laws of some states, like Texas. One simple asset protection step for a person in a high-risk profession is to take maximum advantage of opportunities to contribute to qualified retirement plans.

2. Premarital Agreements

a. Work will be needed to provide for the distribution and ownership of assets for couples about to marry.

3. Limited Partnerships

a. The family-owned partnership has become a popular vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. The family partnership provides a number of benefits, both tax and non-tax, including valuation discounts, transfers of value without relinquishing control, and restrictions on further transfer of limited partnership interests.

b. With respect to asset protection planning, a limited partner's personal exposure for the debts of the partnership is generally limited to his investment in the partnership. This prevents a creditor of the partnership from reaching the personal assets of a limited partner to satisfy debts owed by the partnership.

c. A limited partnership also can provide a modest level of creditor protection against creditors of a partner who are seeking assets to satisfy a debt or judgment. Almost every state has enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"). RULPA helps protect a limited partnership interest from the claims of creditors of the partner by mandating an unattractive remedy for a creditor seeking that partner's interest.

d. Usually, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. Section 703 of RULPA provides that a court may charge the

partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. Under Section 702 of RULPA, the assignee judgment creditor is only entitled to receive those distributions to which the debtor partner would have been entitled, unless there is a contrary provision in the partnership agreement. The effect of the charging order is that a partner's creditor will only receive those partnership distributions which, absent the charging order, would have been distributed to the debtor partner.

4. Limited Liability Companies

   a. The limited liability company ("LLC") is a viable alternative to the use of a limited partnership. The LLC first became available in Wyoming in 1977 and is now available in almost every state. The LLC has the limited liability of a corporation, but preserves the flow through treatment of taxable income (or loss) of a partnership. The LLC can provide an attractive alternative to the use of a general or limited partnership, especially where there is a desire to limit the personal liability of the family members in relation to the activities of the entity.

   b. With respect to asset protection issues, many state LLC statutes contain charging order sections similar to that found in the RULPA. Also, LLC statutes generally contain the following types of provisions which provide protection quite similar to the protection afforded by a limited partnership:

      (1) A member's interest in an LLC is personal property and is not an interest in specific assets of the LLC;

      (2) An assignee will not become a member of the LLC without the unanimous consent of the other members; and

      (3) An assignee who is not a member is only entitled to receive the share of profits and income to which the assignor is entitled and has no right to participate in the management of the LLC.

5. Domestic Asset Protection Trusts

   a. Certain states permit the settlor of an irrevocable trust to obtain spendthrift protection from an irrevocable trust if certain require are met.

   b. While Missouri was the first state to enact Domestic Asset Protection Trust legislation in 1986, few attorneys outside of

Missouri paid attention to it or were even aware of it. However Domestic Protection Trusts gained public awareness when, in 1997, both Alaska and Delaware enacted legislation permitting Domestic Protection Trusts.

c. As of May 13, 2017 the following 18 states allow such self-settled asset protection trusts: Alaska, Colorado, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

d. The basic requirements in each of these Domestic Asset Protection States are:

(1) There must be a resident trustee in the state.

(2) Some of the assets of the trust must be held in the state.

(3) Some of the administration of the trust must take place in the state.

(4) The transfer of assets to the domestic asset protection trust cannot be a transfer in fraud of creditors.

(5) The trust must be irrevocable.

(6) The settlor is a discretionary beneficiary of the income and principal of the trust.

6. Offshore Protection Trusts

a. Offshore Protection Trusts have become one of the most talked about estate planning techniques for many years. They are heavily promoted as effective barriers against claims of creditors because the laws of most offshore trust havens make it difficult for creditors to obtain jurisdiction over, or levy against, a trust, even if the settlor retains an interest in the trust property. Unlike most states of the United States, a number of foreign jurisdictions, usually former British colonies or current British dependencies permit a settlor to create a spendthrift trust for his or her own benefit. These barriers often insulate the property entirely from creditors, or produce early and inexpensive settlements.

b. Creditor Protection Benefits

(1) An Offshore Protection Trust can create geographic, legal, procedural, and financial hurdles to reaching its assets.

(2) The mere fact that a trust is a foreign trust may deter creditors from pursuing the trust. This is particularly likely if the trust is funded with assets from the foreign jurisdiction. The cost of pursuing a claim against a foreign trust can be high, especially since foreign jurisdictions may prohibit contingent fee litigation or require significant deposits to commence a proceeding.

(3) Some jurisdictions, such as the Cook Islands, do not recognize foreign judgments. Thus, an action first brought in a United States court may have to be tried all over in a foreign jurisdiction.

(4) As mentioned, many foreign jurisdictions have favorable spendthrift trust provisions which protect the interests of a settlor-beneficiary. Such provisions are in contrast to dominant rule in the United States that one may not create a spendthrift trust for one's own benefit.

7. If the estate, gift, and generation-skipping transfer tax are repealed, individuals may still want to establish long-lasting trusts that could last several generations to protect assets from creditors and also protect the assets in the trust from the imposition of a future estate, gift, or generation-skipping transfer tax. The United States is, as noted above, currently on its fourth estate tax. There is no guarantee that a future Congress will not enact new estate, gift, or generation-skipping transfer taxes.

a. The ability to established long-term irrevocable trusts for several generations has been greatly aided by the enactments of laws in many states that have either eliminated or greatly extended the common law rule against perpetuities. In fact, without a gift tax, unlimited amounts could be placed in such a trust.

b. The common law Rule Against Perpetuities (the "Rule") provides that no interest is good unless it vests or fails within a life in being plus twenty-one years.[4] Currently, twenty states effectively have abolished the Rule. Nine states have repealed the Rule outright. A tenth (Delaware) has repealed the Rule with respect to interests in personal property. An additional nine states and the District of Columbia have preserved the Rule, but have granted trust settlors the authority to opt out of it by including specified provisions in their trust instruments. In 2000 Florida extended the perpetuities period to 360 years,[5] and in 2001 Washington extended it to 150 years.[6] In 2003, Utah extended its perpetuities period to 1,000 years.[7] Also, in 2003, Wyoming adopted an opt-out provision for personal property and extended the perpetuities period to 1,000

years.[8] In 2005, Nevada extended the perpetuities period to 365 years.[9] In 2006, Colorado extended the perpetuities period to 1000 years.[10] In 2007, Tennessee extended the perpetuities period to 360 years.[11]

c. Repeal Legislation. Statutory provisions in Alaska, Idaho, Kentucky, New Jersey, Rhode Island, South Dakota, and Wisconsin each provide that the Rule is not in force in the respective states, while Pennsylvania provides for this for interests created after December 31, 2006.[12] Statutes in effect in Idaho, South Dakota, and Wisconsin provide that the repeal of the Rule applies retroactively.[13] By contrast, New Jersey's statute provides that it shall not be applied retroactively.[14] It is unclear whether the repeal of the Rule in Alaska or Rhode Island applies retroactively[15]. North Carolina repealed the Rule Against Perpetuities effective August 9, 2007.[16] A state constitutional problem arose because of the provision of Section 34 of Article I of the North Carolina Constitution that provides "Perpetuities and monopolies are against the genius of a free state and shall not be allowed." On February 2, 2010, the North Carolina Appellate Court upheld the constitutionality of the North Carolina repeal.[17] Hawaii repealed the Rule with respect to its form of domestic asset protection trust that became effective July 1, 2010.[18]

d. Delaware and Michigan Partial Repeal Legislation. Delaware has repealed the Rule only with respect to interests in personal property,[19] but replaced the common law Rule with a perpetuities period of 110 years for real property held in trust.[20] It is unclear whether either of these provisions apply retroactively to existing trusts. Michigan has repealed the Rule with respect to personal property effective May 28, 2008.[21]

e. Opt-Out Legislation. The remaining twelve states (plus the District of Columbia) that have effectively abolished the Rule have done so by providing settlors with the power to opt out of the Rule's application to their trusts. These states include Illinois, Maine, Maryland, Ohio, Arizona, Colorado, Missouri, New Hampshire, Virginia, and Wyoming.

D. Lifetime Planning if the Gift Tax is not Repealed

1. If the estate and generation-skipping transfer taxes are repealed, but the gift tax is retained, then planners will still continue to use various techniques to avoid gift tax for clients and customers who wish to transfer assets to family members and others without gift tax consequences. This will admittedly apply primarily to high net worth taxpayers.

2. Irrevocable Life Insurance Trusts

   a. Clients may still create irrevocable life insurance trusts as a way to transfer the death benefits of life insurance policies to family members without adverse gift tax consequences even if there are no estate tax consequences. They may do so to provide creditor protection to the beneficiaries, to retain control over the ultimate disposition of the assets in the irrevocable life insurance trusts, and to protect those assets against a possible future reimposition of the estate tax.

   b. This will require planning in many instances to qualify transfers to the trusts for the gift tax annual exclusion through the use of Crummey powers and to minimize the exposure of the holders of the Crummey powers to potential gift tax exposure through the use of vested interests or hanging powers of withdrawal for example.

3. Family Limited Partnerships and Limited Liability Companies

   a. Family limited partnerships and limited liability companies will continue, if there is a gift tax, to be used for managing assets and obtaining discounts for gift tax purposes. In addition, as discussed above, family limited partnerships and limited liability companies provide a certain degree of protection from creditors.

   b. The lack of marketability and minority interest discounts will likely be available to allow individuals to gift interests in a family limited partnership or limited liability company at a value below that of the value of the underlying assets of the family limited partnership or limited liability company.

   c. Although the IRS has been hostile toward the valuation discounts that have been obtained in many instances for testamentary and lifetime transfers of family limited partnership or limited liability company interests, efforts to restrict those discounts, such as the proposed regulations under Section 2704 may come to naught in light of the unfavorable reaction of Republican Senators and Representatives to the proposed regulations and the advent of a Republican administration in 2017.

4. <u>Split Interest Techniques</u>. If there is still a gift tax while the estate tax is repealed, individuals will use split interest gifts such as Grantor Retained Annuity and Unitrusts and Grantor Retained Income Trusts (especially Qualified Personal Residence Trusts) as a way to leverage a donor's applicable exclusion amount. Sales to Defective Grantor Trusts will likely be used as an alternative to Grantor Retained Annuity Trusts since they involve no use of a donor's applicable exclusion amount.

E. Planning for Carryover Basis or a Capital Gains Tax at Death

1. Planning for carryover basis when a person dies may become complicated, especially if there is some form of modified carryover basis regime similar to that enacted as part of the 2001 Tax Act.

    a. In the 2001 Tax Act, there was a basis increase of $1.3 million provided for each taxpayer and an additional basis increase of $3 million for property passing to a surviving spouse.

    b. Some commentators have discussed a basis increase of as much as $5 million indexed for inflation for each decedent if any repeal of the estate tax includes carryover basis. Planning will be required for this.

    c. This may make insurance more popular as an asset since the proceeds are received as cash when the insured dies and there are no capital gains tax consequences.

2. Likewise, if there is a capital gains tax at death, planning will have to be done for the payment of that tax. Many issues would arise in drafting such a tax. These issues include:

    a. How would the tax be reported and when would the tax be due?

    b. Would there be some form of modified basis step-up?

    c. Would there be a marital deduction or special basis step-up for property passing to a surviving spouse?

    d. Would there be special provisions for the payment of the capital gains tax owed at an individual's death such as special use valuation of deferral of the payment of the tax?

F. Income Tax Planning

1. No matter what happens with respect to taxes, clients will still need advice on both federal and state taxes.

2. Any changes in the federal income tax enacted in 2017 and effective in 2017 or later may affect individuals and entities including corporations, partnerships, and limited liability companies. This will depend upon the parts of the Internal Revenue Code, if any, that Congress revises.

    a. A reduction in the income rates for individual income or corporate tax rates will affect many clients.

b. The elimination of the Alternative Minimum Tax will also have a positive impact.

c. The repeal of the Affordable Care Act, which is part of the Republican platform, should lead to the repeal of the 3.8% tax on net investment income which was enacted to help fund the Affordable Care Act.

d. The elimination of all deductions for individuals, except the home mortgage interest deduction and the charitable deduction, will also affect clients. It also appears that Congress may consider capping the total amount of deductions for high-net-worth taxpayers.

3. Federal Fiduciary Income Tax

a. The fiduciary income tax found in Subchapter J of the Internal Revenue Code is one of the more complex and confusing tax provisions. One wonders if Congress will take any action with respect to Subchapter J when it addresses reform of the Internal Revenue Code in 2017 and later.

b. Among the complex areas of Subchapter J are:

(1) What makes a trust a grantor trust for income tax purposes?

(2) DNI and what it really means.

(3) The lack of simplicity of simple trusts and the complexity of complex trusts.

(4) The limitations on deductibility of trust expenses.

(5) Timing distributions to the advantage of beneficiaries.

(6) Making the Section 645 election work for clients.

(7) The ins and outs of equitable adjustments and private Unitrusts.

4. State Income Taxation of Irrevocable Non-grantor Trusts

a. Currently seven states, Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming, do not tax the income of trusts. The other states and the District of Columbia do tax the income of trusts to a greater or lesser extent.

b. If a trust is treated as a grantor trust for federal income tax purposes, all income (ordinary and capital gains) will be taxed to

the grantor of the trust. Most states follow the federal grantor trust rules. If a trust is a grantor trust for federal income tax purposes, the trust will be treated as a grantor trust for state income tax purposes. Pennsylvania and Tennessee do not follow the federal grantor trust rules for irrevocable trusts and the District of Columbia and Louisiana tax grantors only in limited circumstances.

c. Every state follows the rule that to the extent that income is distributed from an irrevocable non-grantor trust to a beneficiary, the beneficiary pays the tax and not the trust. Consequently, in examining the income taxation of a trust or estate from a state law perspective, one is primarily looking at the taxation of income accumulated in a trust as well as capital gains.

d. In the remainder of this section, the focus will be on the state income taxation of irrevocable non-grantor trusts. Non-grantor irrevocable trusts are generally taxed for state income tax purposes on one or more of the following bases:

(1) The trust was created pursuant to the will of a testator who lived in the state at the time of his or her death.

(2) The creator of an inter vivos trust lived in the state at the time the trust became irrevocable.

(3) The trust is administered in the state.

(4) One or more trustees live or do business in the state.

(5) One or more beneficiaries live in the state.[22]

e. The trust that meets one or more of the bases for taxation in a state is generally referred to as a "Resident Trust."

f. The bases for the state income taxation of non-grantor trusts vary from state to state:

(1) Trust created by will of resident. Connecticut, District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin tax a trust that is created by the will of a decedent who was a resident of the state at the time of his or her death. Other states, such as New Jersey and New York, require that such a trust have Resident Trustees, assets, source income, or a resident beneficiary before they will tax such a trust.[23]

(2) Inter vivos trust created by resident. The District of Columbia, Illinois, Maine, Maryland, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin tax an inter vivos trust if it becomes irrevocable when the creator lived in the state.[24]

(3) Trust administered in the state. Colorado, Georgia, Indiana, Kansas, Louisiana, Maryland, Minnesota, Mississippi, Montana, New Mexico, North Dakota, Oregon, South Carolina, Virginia, and Wisconsin tax the trust if a trust is administered in that state. Idaho and Iowa tax a trust if it is administered in the state if this basis is combined with other factors. Hawaii requires that a trust administered in Hawaii have at least one resident beneficiary for the trust to be taxed in Hawaii. Utah since 2003 has permitted a Utah corporate trustee to deduct all nonsource income of a trust administered in Utah.[25]

(4) Resident Trustee. Arizona, California, Georgia, Kentucky, Montana, New Mexico, North Dakota, Oregon and Virginia tax an irrevocable trust if one or more trustees reside in the state.[26]

(5) Resident beneficiary. California, Georgia, North Carolina, North Dakota and Tennessee tax a trust if it has one or more resident beneficiaries.[27]

g. There are many variations to the bases rules above depending upon the laws of a particular state. One must look at the law of each state in determining whether that state's income tax will apply to a particular trust.

h. As can be seen above, some states apply more than one basis in determining whether a trust is subject to income taxation of that trust. For example, Virginia taxes the income of a non-grantor trust if (i) the trust is created by the will of a Virginia decedent; (ii) the trust is created by a Virginia resident; (iii) the trust is administered in Virginia; or (iv) there is at least one trustee who is a Virginia resident.

i. Examples of different states:

(1) The opportunity for reducing taxes can be important. State fiduciary income tax rates range from 3.07% in Pennsylvania to as high as 12.846% in New York City.

(2) New York. New York defines a Resident Trust as a trust created by a New York resident or grantor. New York does

not tax a trust if a trust has no New York trustees, assets, or source income.

(3) Connecticut. Connecticut basically taxes irrevocable trusts that are created by a Connecticut testator or a person who is a resident of Connecticut at the time the trust became irrevocable.

(4) Delaware. Delaware generally does not impose any income tax upon Resident Trusts except in cases where one or more trust beneficiaries live in Delaware and then only upon the portion of the trust income attributable to the beneficiaries who reside in Delaware.

(5) Maryland. Maryland taxes an irrevocable trust created by a Maryland testator or grantor if the trust was created under the will of a decedent domiciled in Maryland on the date of decedent's death, the creator or grantor of the trust is a current resident of Maryland, or the trust is principally administered in Maryland.

(6) Virginia.

(a) Virginia, as noted above, has a broad definition of a Resident Trust subject to Virginia taxation. The definition is:

> A trust created by the will of a decedent who at his death was domiciled in the Commonwealth; a trust created by or consisting of property of a person domiciled in the Commonwealth; or a trust which is being administered in the Commonwealth.[28]

(b) The Virginia Administrative Code expands on this definition by adding that a trust is considered to be administered in Virginia if "its assets are located in Virginia, its fiduciary is a resident of Virginia or it is under the supervision of a Virginia court."[29]

(7) Missouri. A trust will be subject to Missouri income tax if it was created by the will of a Missouri decedent or it is an inter vivos trust created by a Missouri resident. In addition, the trust must have a resident income beneficiary on the last day of the taxable year if the trust is to be subject to tax in Missouri.

(8) California. A trust is a California resident for income tax purposes if a trustee or non-contingent beneficiary is a resident of California, regardless of the residence of the settlor. With respect to corporate fiduciaries, the residence of the corporate fiduciary is the place in which the corporation conducts the major portion of the administration of the trust.[30]

j. Given the complexity of and the differences between the rules governing the income taxation of trusts and estates by different states, an irrevocable non-grantor trust may be subject to income taxation in more than one state.

k. Responses to DING trusts, NING trusts, and Attempts to Minimize State Income Tax

(1) A "DING" trust, or "Delaware Incomplete Non Grantor" Trust, is an irrevocable trust established under the laws of Delaware. When established in Nevada, such a trust is referred to as a "NING" trust.

(2) Such a trust has the following features:

a. The trust is irrevocably established in a jurisdiction without state income tax on trusts (in the case of a DING, Delaware; and in the case of a NING, Nevada) by a settlor from another jurisdiction;

b. The settlor retains sufficient control such that the trust is treated as an incomplete gift for federal gift tax purposes and does not trigger gift tax upon its creation; and

c. The settlor does not retain any power that would cause the trust to be treated as a "grantor" trust for income tax purposes, such that the trust, and not the settlor, is taxed on the income of the trust.

(3) In a series of private letter rulings, the IRS has confirmed that a trust may be established where the grantor parts with sufficient control such that the settlor is not treated as the grantor for federal income tax purposes, but where the settlor retains sufficient control so that the gift is deemed to be incomplete for federal gift tax purposes.[31]

(4) The DING or NING trust has no savings from federal income tax, because the trust still must pay federal income tax on any income.

(5) However, the trust can offer savings from state income tax, because the trust is designed to be treated as a resident only of the forum state, and the trust would pay no income tax in that state.

(6) Generally, New York taxes "Resident Trusts" on income, regardless of whether that income comes from sources located in New York.

(7) New York's Response to DING/NING Trusts

a. New York law generally defines a "Resident Trust" as:

b. a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this state, or

c. a trust, or portion of a trust, consisting of the property of:

> (i) a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or
>
> (ii) a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable."[32]

d. New York law provides, however, that even if a trust is created by a New York resident as provided above, a Resident Trust is not subject to tax if all of the following are satisfied:

> "(i) all the trustees are domiciled in a state other than New York;
>
> (ii) the entire corpus of the trusts, including real and tangible property, is located outside the state of New York; and
>
> (iii) all income and gains of the trust are derived from or connected with sources outside of the state of New York."[33]

e. Prior Law and DING/NING Trusts by New York Resident. Under prior law, if a trust was created by a New York resident, but has no New York resident trustee, no assets located in New York, and no New York source income, then the trust pays no New York income tax. This tax savings can be considerable. Currently, New York has a state capital gains rate of 8.8%.

f. Current Law and DING/NING Trusts by New York Residents. However, in 2014 New York adopted a statute to expressly address such DING/NING trusts. This law classifies such DING/NING trusts as grantor trusts for purposes of New York state law. This law provides that a trust is treated as a Resident Trust if the grantor is a New York resident, if the transferor is not treated as grantor for federal tax purposes, and if the transfer to the trust is an incomplete gift for federal gift tax purposes. The statute taxes in New York the assets of an "incomplete gift non-grantor trust," which is defined as follows:

> an "incomplete gift non-grantor trust" means a resident trust that meets the following conditions: (i) the trust does not qualify as a grantor trust under … the Internal Revenue Code, and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift under … the Internal Revenue Code, and the regulations thereunder.[34]

That is, the statute expressly reaches trusts which (1) are non-grantor trust for federal income tax purposes, and (2) result from an incomplete gift for federal income tax purposes.

G. Charitable Planning

1. Many opportunities exist for enhanced charitable giving by trust and private banking customers. This is especially true when one examines the history of charitable giving by Americans.

a. Americans are among the most generous people, ranking second only to Canadians in terms of average donations to charity.

b. In 2015, Americans gave $373.25 billion to charities. This was a $14.2 billion increase over charitable giving in 2014 (Giving USA 2016: The Annual Report on Philanthropy for the Year 2015, published by Giving USA Foundation, and researched and written by the Center on Philanthropy at Indiana University).

c. Individuals gave $264.58 billion and contributed 71¢ of each dollar given to charity in 2015.

d. Bequests totaled $31.76 billion in 2015.

e. Corporate giving was $18.45 billion in 2015.

f. Far more than one million charities are presently recognized by the IRS.

2. Given the generosity of individuals, coupled with the overwhelming value of the future transfer of wealth between generations, Many opportunities will exist for charitable planning no matter what happens in the future,

3. Income Tax Deduction for Charitable Contributions. The deductibility of charitable contributions for income tax purposes is subject to two types of limitations. These two limitations often make charitable planning challenging.

   a. Percentage Limitations. There are "percentage limitations" on the amount that an individual may claim as a charitable deduction against his gross income in any tax year.

   b. Valuation Limitations. With respect to certain appreciated property contributed to charity, the individual may be required to use the property's tax basis, rather than its fair market value at the time of the contribution, for the purpose of determining the deductible amount of the contribution.

4. Substantiation Requirements. The IRS may disallow an individual's income tax charitable deduction if it is not properly substantiated. Recordkeeping requirements apply to all charitable contributions. Additional appraisal requirements apply to certain large contributions of property, other than cash or publicly traded securities.

5. Split interest charitable gifts, especially lifetime charitable remainder trusts (which provide an income tax charitable deduction for the remainder interest), will continue to be used if there is no estate tax. If the estate tax is repealed, but the gift tax is not, charitable lead trusts, especially charitable lead annuity trusts which can be "zeroed out," will be popular.

6. High worth clients will need advice on setting up private foundations with all of their restrictions and limitations and donor advised funds.

H. Retirement Benefits

1. For all estate planning professionals who represent and work with executives, business owners, and self-employed professionals, planning for retirement benefits is critical.

2. Retirement benefits will be the single largest asset of many individuals. It is common for retirement benefits to have a value in the hundreds of thousands of dollars, and benefits exceeding one million dollars are by no means rare. Ownership and receipt of retirement benefits will entail significant income tax consequences even if there is no estate tax.

3. Given the complexity of retirement plans, clients need advice in navigating the distinctions between qualified and non-qualified benefits and understanding the differences between, for example, defined benefit and defined contribution plans and regular IRA's and Roth IRAs.

I. Elder Law

1. Estate planning for the elderly and incapacitated presents unique challenges. On the non-tax front, there may be questions of the individual's competence, or ability to understand the estate planning alternatives being considered. Communication may be a challenge due to physical disability. There may be questions of influence by other family members.

2. Elderly clients often have special concerns related to health care and extended care arrangements for themselves.

3. If the person is mentally incapacitated, and needs estate planning, there are both special procedures and special challenges in determining the person's presumed intent.

4. As the American population ages, more and more people will need advice on issues such as financial planning, housing, long-term care insurance, Medicare, and Medicaid.

J. Business Planning

1. Advising closely held businesses on non-tax and tax issues will continue to be important even if there is no estate tax.

2. Non-Tax Issues:

a. Experts estimate that 85% of the crises faced by family businesses focus around the issue of succession.[35] Therefore, in addition to addressing the legal aspects of passing a family business from one generation to the next, attorneys, accountants, family business consultants, trust officers, and other professionals must help families meet and overcome the conflict that will inevitably occur when a family plans for the succession of the control and/or ownership. In fact, such conflict is, in most situations, inescapable. Experts tell us that conflict is a necessary part of human relationships. Human beings are incapable of spending any significant time together without having differences.[36]

b. Surmounting the challenges of this conflict requires both sensitivity to family dynamics and an extensive knowledge of the wide range of legal disciplines that impact succession issues.

c. Lack of Succession Planning. Despite the importance of succession planning, a 2007 survey of family businesses found that 40.3% of business owners expected to retire within 10 years. But of those business owners expecting to retire in 5 years, only about half (45.5%) had selected a successor, and of those expecting to retire in 6–11 years, only 29% had selected a successor.37 But 30.5% had no plans to retire, ever; and since the median age of the business owner was 51, many planned to die in office.38

d. Human Planning Requirements. A business owner who fails to prepare and execute a succession plan—and especially one who dies in office—leaves his or her family, business, and wealth in a uncertain state subject to questions about what should be done with the business and attacks by those who wish to take control or have ownership or those who think that they are entitled to ownership and control.

3. Planners will have to advise closely held and family owned businesses on a variety of tax issues as well:

a. Buy-Sell Agreements

(1) The buy-sell agreement is a contract among the owners of a business, or between the owners and the company, which sets out what will happen to their various ownership interests upon the occurrence of certain specified future events (such as death or withdrawal). Buy-sell agreements are used primarily to achieve non-tax goals. They can serve a number of useful purposes in a family business, before, during and after a period of succession.

(2) Control. A typical agreement will give the entity, the owner, or both a right of first refusal on certain proposed transfers by a shareholder. This protects the existing owners from unwillingly becoming business partners with an undesirable owner. It may permit a senior family member who controls the business to become comfortable with making gifts of stock, since the agreement will give him or her some control over what his children do with the stock.

(3) Liquidity. A buy-sell agreement can provide a withdrawing family member with a market for his or her interest by providing a put right in certain circumstances. The most common point in time to grant a put right is at the death of a shareholder. It allows a surviving spouse or children who are not interested in continuing in the business to liquidate their interest. Put rights also can be granted at retirement or when the shareholder ceases to be employed with the business for other reasons.

(4) Planning. A buy-sell agreement helps push a family toward further succession planning by focusing them on what options should be given to the family of a deceased shareholder and how to fund the repurchase of stock under the agreement.

(5) Preservation of Tax Benefits. It is also possible to include in a buy-sell agreement prohibitions against certain actions by the shareholder that would threaten tax elections. A buy-sell agreement for an S corporation typically prohibits a shareholder from transferring stock to an entity or person that is not a permissible shareholder of an S corporation, or from taking any other action that would threaten the S election.

b. Once it is determined that a buy-sell agreement is desirable, the next determination must be who the operative parties to the agreement will be. Obviously, the withdrawing party will be the seller, but the purchaser may be the other owners (a cross purchase), the business itself (an entity purchase), or a combination of the two. Except to the extent that tax consequences may vary, the seller is generally not concerned with the question of who acts as the purchaser (assuming that the purchase price is paid in full at closing). He is concerned only with getting the appropriate amount of money for his interest. However, it is important that the purchaser be identified and that steps be taken to ensure that the purchaser has the funds necessary to make the required purchase.

(1) Cross-Purchase Agreement. A buyer will often prefer a cross-purchase agreement since this will result in an increase in the buyer's basis in his stock. If the other shareholders are to make the purchase, it is often desirable for them to take out insurance on one another's lives so that funds will be available to make the purchase. Obviously, with a large number of shareholders, this can be very expensive as well as administratively cumbersome. If this type of cross-purchase arrangement is structured, at the death or withdrawal of one shareholder, the policies he holds on the lives of the other shareholders must be assigned to the remaining shareholders. Younger shareholders may bear a disproportionate burden of the cost of such agreements because the policies on the lives of the older stockholders, which they must purchase, will have higher premiums than the policies on their lives, which the older stockholders must purchase.

Generally, the cross purchase of insurance by the shareholders is not associated with any adverse income tax consequences. When the surviving shareholders receive the insurance proceeds on the deceased shareholder's life at his death, those proceeds will not normally constitute taxable income to them. When they purchase the stock from the decedent's estate, no significant taxable gains should occur because, by reason of the decedent's death, the estate has received a step-up in the income tax basis of the stock being sold. Moreover, the full amount paid for the stock so acquired is included in the surviving stockholders' income tax basis for that stock, so any subsequent sale of the business by them would result in their realizing less capital gain.

Although no income tax problems generally result from cross-purchase agreements, if the insurance policies are transferred among the remaining owners, problems can arise as a result of changes in stock ownership. In these cases, assignments of the policies may run afoul of the "transfer for value" rules of the tax law (Section 101(a)(2)) and may cause the proceeds of the insurance to be fully income taxable when the transferee shareholder collects them.

If corporate earnings are to be the principal source of premium payments, additional problems are created. When the shareholders own the policies, any premium payments by the corporation will be income to the shareholders. If

the company owns the policies but distributes the proceeds to the surviving shareholders to allow them to make the purchase, the proceeds may be a taxable dividend.

(2) Entity Purchase Agreement. Alternatively, the buy-sell agreement can be structured to have the business itself (rather than the other owners) be the ultimate purchaser at the time of the withdrawal or death of any of the owners.

This alternative may seem attractive if the corporation has sufficient funds to affect the purchase; however, accumulating such funds could cause the corporation to run afoul of the "unreasonable accumulation of earnings" provisions in the income tax law. Sections §§ 531–537.

If the corporation does not have sufficient funds to affect purchases at the death of an owner, it could acquire insurance for such purchases. Only one policy on the life of each shareholder would be necessary, and there would be no need for transfers of policies, eliminating concern over the "transfer for value" rules. Further, the cost differences of policies between shareholders of various ages are equalized (because the corporation pays for all policies).

The receipt of insurance proceeds by a C Corporation could have income tax consequences. While insurance proceeds received by the corporation are not subject to regular income tax liability, they may now be subject to the corporate alternative minimum tax. Under the alternative minimum tax, the corporation must add to its tax base one-half of the amount of the proceeds received for the taxable year. This may result in additional tax owed by the corporation, which will either reduce the amount of after-tax proceeds available to be used for the stock purchase, or reduce the corporation's surplus (and thus, its value to the remaining shareholders). While this potential tax cost itself can be insured for by increasing the amount of insurance coverage carried on the shareholders, this could be expensive.

Although having the corporation serve as the purchaser in the buy-sell agreement may appear desirable, there are certain disadvantages. First, such purchases constitute redemptions for income tax purposes. As is discussed in detail later in this chapter, unless certain very specific requirements are met, the amounts distributed from the

corporation for the stock interest constitute dividend income to the recipient. The tax consequences of this to the recipient would be undesirable in that the proceeds, instead of being nearly tax free, would be taxable as ordinary income. Accordingly, in structuring a corporate redemption, one must ensure that the redemption will qualify as (a) substantially disproportionate, (b) a complete termination of interest, or (c) a redemption to pay death taxes.

Moreover, the remaining shareholders may face potential capital gains problems. When the corporation purchases the selling shareholder's shares, the value of the remaining owners' shares may increase, although their income tax basis in the shares will not. The value of the corporation, and accordingly the outstanding stock, may also be increased by the receipt of insurance proceeds by the corporation. A subsequent sale of a remaining shareholder's interest may thus result in a large capital gain.

One final potential tax trap with regard to buy-sell agreements should be recognized. Sometimes such agreements are structured to require the surviving shareholders to purchase the stock at the death of one of them, but then, at the time of sale and purchase, it is determined that the corporation has adequate funds to make the purchase. Even if it is possible to structure a purchase by the corporation that will not be taxable as a dividend to the recipient, an unintended dividend to the surviving shareholders may be imputed for income tax purposes. This would be the case if a primary, unconditional obligation of such shareholders (the requirement to purchase the stock) were satisfied by the corporation. To avoid this result, the buy-sell agreement should generally not impose a primary unconditional obligation on the surviving shareholders but should give the corporation the first right to purchase and should make the shareholders obligated to purchase only if the right is not exercised.

4. Redemptions of Stock under Section 302 of the Internal Revenue Code

a. A redemption of a shareholder's stock by the business is a very effective way to terminate or reduce the shareholder's interest in the business and provide him or her with liquidity. The business itself is often in the best position to fund a buy-out of a shareholder. Provisions for redemption of stock are often found in

buy-sell agreements, and are frequently privately negotiated when a shareholder wishes to liquidate his or her investment.

b. A major problem in planning for redemptions (at least with respect to C corporations) is that if the corporation purchases the stock of a shareholder, pursuant to a buy-sell agreement or otherwise, the proceeds paid to the shareholder will be treated as dividend income, rather than proceeds from a sale, unless the redemption qualifies as an exchange under Section 302 or 303 of the Code.

c. A redemption will only qualify for exchange treatment only if the redemption: (a) is "substantially disproportionate," (b) results in a "complete termination of the shareholder's interest, (c) is not "essentially equivalent to a dividend" in light of all relevant facts and circumstances, or (d) is necessary to pay estate taxes resulting from inclusion of the closely held stock in the shareholder's estate. Of course, this last type of redemption qualifying for exchange treatment will no longer be applicable if the estate tax is repealed.

5. S Corporations. Much planning will have to be done for S Corporations. There are over 3.5 million S Corporations.

a. Definition of S Corporation. Subchapter S of Chapter 1 of the Internal Revenue Code permits an electing corporation to be taxed in a manner similar to a partnership and thereby avoid double taxation on corporate earnings. Generally speaking, an S corporation is not taxable as a separate entity. Instead, the corporation's income, loss, deductions, and credits are passed through pro rata to its shareholders, who must include these items in the computation of their separate income taxes (Section 1366). Section 1361(b)(1) sets out the requirements that must be satisfied in order for a corporation to elect and maintain S corporation status.

b. Requirements for S Corporation Status

(1) No more than 100 shareholders;

(2) No shareholders other than individuals, estates, certain trusts, and, as of January 1, 1998, certain tax-exempt organizations. The only tax-exempt organizations that qualify are charitable organizations described in Section 501(c)(3) and qualified retirement plans described in Section 401(a);

(3) No nonresident alien shareholders;

(4) No more than one class of stock (for these purposes, differences in voting rights among the shares of common stock are disregarded); and

(5) No membership in an affiliated group determined under Section 1504.

c. Shareholder Consent to S Election. If the foregoing requirements are met, all shareholders must consent to making the S election before the election can be validly made (Section 1362(a)). Once the election has been made, it applies for all succeeding taxable years, so long as the corporation continues to meet the qualifying requirements. The election can also be voluntarily revoked in certain cases.

d. Trusts That Can Hold S Corporation Stock. Section 1361(c)(2) specifies six types of trusts that will qualify as S corporation shareholders:

(1) A voting trust;

(2) A trust, all of which is treated as owned by an individual who is a citizen or resident of the United States under the grantor trust rules of Sections 671–678;

(3) A trust that was a grantor-type trust (including a Qualified Subchapter S Trust ("QSST") for which a qualified election was made) immediately before the death of the deemed owner and that continues in existence after that person's death, but only for a period of two years;

(4) An otherwise nonqualifying trust to which stock was transferred pursuant to a shareholder's will, but only for a period of two years beginning on the date of transfer;

(5) An Electing Small Business Trust ("ESBT"), defined under Section 1361(e), for which a qualifying election is made; and

(6) A QSST, defined under Section 1361(d)(3), for which a qualifying election is made.

6. Employee Stock Ownership Plans ("ESOP"). An ESOP is a defined contribution retirement plan designed to invest primarily in employer securities. Section 4975(e)(7). An ESOP is separate from the family business so a sale to the ESOP is not a redemption, and the rules for qualification of a redemption as an exchange (rather than a dividend) do not apply.

K. Trust Administration and Fiduciary Litigation

1. A repeal of the estate tax may mean that individuals will place more assets and funds in trust than currently, because assets will no longer be depleted to pay estate, gift, and generation-skipping transfer taxes. The more assets that are in trust, the more likely that beneficiaries will fight with themselves or contest the actions of trustees. Thus, a repeal of the estate tax will likely lead to more fiduciary litigation than currently.

   a. With the rise of the use of irrevocable trusts for tax and non-tax reasons, draftspersons and settlors are looking ways to provide for flexibility in these irrevocable trusts. There will be a growing need for advice on this. Methods that are used include:

      (1) Lifetime and testamentary powers of appointment.

      (2) The use of trust directors or protectors who have powers to amend the provisions of irrevocable trusts.

      (3) Reformations.

      (4) Non-Judicial Settlement Agreements under the Uniform Trust Code.

   b. An increase in fiduciary litigation or fiduciary disputes could lead to more work for estate planning professionals as expert witnesses, mediators, or arbitrators.

   c. In addition, an increase in the amount of assets held in trust because of a repeal of the estate tax could result in the need for more investment advice with respect to the appropriate assets to be held in particular trusts.

L. Mediation or Arbitration

1. Mediation of disputes which is non-binding or arbitration of disputes which is binding may be a way of resolving disputes involving trusts.

2. The trust instrument might simply provide that in the event of disagreement between two individuals—such as a disagreement between two trustees, or a disagreement in a valuation of trust property that might affect two beneficiaries—those individuals must submit the dispute to a third party, whose determination is binding.

3. Of course, such a submission to a third party might be easier envisioned than executed. The two individuals frequently disagree on which third party should resolve the issue.

4. A common alternative is to provide that each party may select a representative, and then those two representatives select the third, neutral party. This is a common approach in disputes over real estate, in which the two appraisers select a third appraiser, whose determination is binding.

> **SAMPLE TRUST PROVISION:** In the event that two or more Trustees are then serving, and in the event the Co-Trustees cannot reach a unanimous agreement on a course of action, the Co-Trustees shall unanimously select any individual, bank, trust company, or other entity having trust powers (the "Neutral Party"), who shall decide the issue submitted, and whose decision on said issue shall be binding on all parties. In the event that the Co-Trustees cannot agree on the selection of a Neutral Party, then each Co-Trustee shall have the right to select a Neutral Party, and those Neutral Parties shall unanimously select a further Neutral Party, which further Neutral Party shall decide the issue submitted, and whose decision shall be binding on all parties.

5. There is one important limitation to this submission to a third party: case law suggests that even in this case, the decision of the third party may not be absolutely binding. Instead, the decision may still be reviewed by a court to ensure that the third party acted in good faith, consistent with his or her fiduciary duties.

6. Because of this uncertainty about the ultimate enforceability of such a provision for resolution within the instrument, a grantor may be better served to insert a specific clause requiring submission of the dispute to a formal arbitration. But as discussed in the following section, those arbitration clauses, too, raise doubts about enforceability.

M. Enforceable Arbitration or Mediation Clauses

1. Introduction

a. An arbitration or mediation clause in a trust would require trustees, beneficiaries, and other individuals involved in a dispute over a trust to submit that dispute to an alternative forum of conflict resolution.

b. In mediation, a third party brings the sides together and works with them to develop a voluntary resolution that all parties can voluntarily enter. But the parties must voluntarily agree on such a resolution; if the mediator is unsuccessful in leading the sides to reach such an agreement, then the sides proceed with other means of resolving their disputes.

c. In arbitration, by contrast, the parties submit their dispute to a third party, who resolves that dispute in a binding fashion.

d. Benefits of Arbitration and Mediation

(1) Mediation and arbitration have certain benefits, particularly in the case of disputes over trust matters. This process can take a much shorter time period, thereby heading off a long and bitter family disputes, and lessening the chance that the dispute will embitter family members over years of litigation. Reducing the length of the dispute also reduces costs for both the trust and beneficiaries.

(2) Because of these benefits, grantors in particular might favor the inclusion of a clause in the trust that requires parties to submit the dispute to mediation or arbitration. The grantor might understandably feel that the trust should not exist as a setting for family members to fight over the trust assets, and the grantor might also be concerned that such disputes will burn up the trust assets in litigation.

2. Background Principles of Law

a. Despite the potential advantages of arbitration and mediation clauses, and despite the apparent support that such clauses would have from grantors, current case law probably would not enforce such a clause.

b. An arbitration clause is not favored under the common law, because it is seen to rob parties of their right to have their dispute resolved in court.

c. Instead, an arbitration clause is only enforceable if authorized by statute. Only two states have specifically authorized arbitration clauses in trust by statute.

(1) Florida law also would enforce "[a] provision in a will or trust requiring the arbitration of disputes, other than disputes of the validity of all or a part of a will or trust." See Fla. Stat. Ann. § 731.401.

(2) Arizona law generally makes enforceable any provision in a trust for "mandatory, exclusive and reasonable procedures to resolve issues … with regard to the administration or distribution of the trust." See Ariz. Rev. Stat. Ann. § 14-10205.

d. Absent such a specific statutory authorization, an arbitration clause in a trust would be evaluated under the state's general arbitration statute. Most states' arbitration statutes provide that an arbitration clause is enforceable if it is contained within a "written agreement" or "written contract."

e. Until recently, the few cases that had addressed this issue had held that an arbitration provision in a trust is not enforceable against the trustees or beneficiaries.

(1) In Schoneberger v. Oelze, 96 P.3d 1078 (Ariz. Ct. App. 2004), the Arizona Court of Appeals reasoned that because Arizona would only enforce an arbitration provision in a "written contract," and because a trust is not a "contract," an arbitration provision is not enforceable in a trust.

(2) Similarly, in In re Calomiris, 894 A.2d 408 (D.C. Ct. App. 2006), the D.C. Court of Appeals held that such a provision in a will is not enforceable, because a will is not a contract, either.

3. Recent Case Law. In two recent cases, courts have suggested that under certain circumstances, an arbitration provision in a trust might be enforceable against a beneficiary.

a. Rachal v. Reitz, 403 S.W.3d 840 (Tex. 2013). In Rachal, the Texas Supreme Court held that a beneficiary was bound by an arbitration provision in a trust. Because the beneficiary attempted to enforce his rights to the other provisions of the trust, he was deemed to have consented to the other terms of the trust, including its arbitration provision.

(1) In 2000, Andrew Francis Reitz created a revocable trust, naming himself as initial trustee. As successor trustee he named Hal Rachal, Jr., the attorney who drafted the trust. The trust provided that upon Andrew's death, the trust assets would be held for the benefit of Andrew's sons, James and John. The trust contained an arbitration clause, which required all disputes to be submitted to arbitration.

(2) After Andrew's death, Hal became trustee. John sued Hal, alleging what the Texas court called "systematic looting" of the trust. Hal invoked the arbitration clause and moved the court to compel arbitration.

(3) The Texas Supreme Court reasoned that Texas law would enforce a "written agreement" to arbitrate disputes. It further noted that a party can be deemed to "agree" to an

instrument if he sues to enforce his rights under that instrument. Because John was suing to enforce his rights under the instrument, he was deemed to have consented to the other provisions of the trust, including the arbitration clause. The court reasoned that it would be "incongruous" to let John sue to enforce his rights as beneficiary of the trust, but to allow John to ignore the arbitration clause in the same trust.

b. McArthur v. MacArthur, 224 Cal.App.4th 651 (2014). In McArthur, a California appellate court confirmed the reasoning of Rachal that a beneficiary who challenges the entire instrument which contains the arbitration provision, and who does not seek any benefit under the instrument can avoid being deemed to consent to the terms of the arbitration provision.

(1) In 2001, Frances McArthur created an inter vivos trust, which upon her death would divide Frances' assets into equal shares for her three daughters. In January 2011, Frances executed an amendment to the trust, by which she allocated a larger portion to her daughter Kristi, designated Kristi as a co-trustee, and required that any disputes related to the trust be submitted to mediation and arbitration. Frances died in August 2011.

(2) Following Frances' death, her daughter Pamela contested the 2011 amendment to the trust. She claimed that the amendment was the result of undue influence and that Frances lacked testamentary capacity when it was executed. Kristi moved to compel arbitration to resolve Paula's claims.

(3) Under California law (as in Texas law at issue in Rachal), a "written agreement" to arbitrate future disputes is enforceable against the parties.

(4) The court reasoned that because Pamela contested the 2011 amendment itself, which contained the arbitration provision, she was not deemed to have consented to the terms of the 2011 amendment. The court held that Pamela was therefore not bound by the arbitration provision, and she could proceed in court.

N. Decanting. This is a technique under which a trustee of a current trust may create a new trust and transfer assets to the new trust. Given the differences between the law of the different states that permit decanting either by case law or statute, advice will be needed on decanting.

1. Exercise of discretionary distribution power to create trust. In Florida, before the enactment of its decanting statute, in certain circumstances, a trustee may have been able to create a new trust for a beneficiary through the exercise of a discretionary distribution power. In Phipps v. Palm Beach Trust Co.,[39] the Florida Supreme Court held that a trust authorizing the trustee to pay all or any part of the principal or income of the trust in such proportions as the trustee determined gave the trustee a "special power of appointment" under which the trustee could create a new trust for any one or more of the beneficiaries of the current trust. The Phipps court believed that the power vested in a trustee to create a fee interest through an outright distribution included the power to create or appoint an estate less than a fee unless the donor indicated a contrary intent. Under the Phipps holding, if a trustee has the discretionary authority to distribute income and principal to a beneficiary, the trustee could create a trust for a problem beneficiary and distribute property to the trust rather than distributing the property outright to the beneficiary. Whether courts in other states without a decanting statute would be as expansive in their reading of an outright distribution power is unclear. However, for a trustee willing to exercise the power to create a new trust, this might provide a solution. Massachusetts has also permitted decanting by case law in Morse v. Kraft in 2013.[40]

2. Uniform Trust Decanting Act

    a. The Uniform Trust Decanting Act ("UTDA") was promulgated by the Uniform Law Commission in 2015. The purpose was to provide a more complete set of rules for decanting than currently exist in any state.

    b. The UTDA has a stricter set of rules that apply when the settlor gave the trustee limited discretion over distributions and a more liberal set of rules when the trustee has expanded discretion. The person exercising the decanting powers is subject to all applicable fiduciary duties. This includes the duty to act in accordance with the purposes of the first trust.

    c. A trustee with limited discretion over distributions may distribute for administrative or tax purposes, but the beneficial interests under the new trust must be substantially similar to the interests under the first trust. This prevents a trustee with limited discretion from reducing or eliminating the interest of any beneficiary.

    d. A trustee with "expanded" discretion has the ability to reduce or eliminate the interests of beneficiaries under the first trust.

    e. The UTDA limits decanting when it would defeat the charitable or tax-related purpose of the settlor.

f. The UTDA prohibits decanting for the purpose of adjusting trustee compensation without the unanimous consent of the beneficiaries or court approval.

g. The trustee is supposed to give sixty days' notice of the intention to decant to interested parties including the settlor, the beneficiaries, holders of presently exercisable powers of appointment, and holders of the power to remove the current trustee.

h. The UTDA has, as of May 13, 2017, been enacted in four states, Colorado, New Mexico, Virginia, and Washington.

3. Decanting Statutes. Twenty-five states now have statutes under which a trustee, pursuant to a power to distribute trust assets outright, may appoint trust assets in favor of another trust. These states are:

1. Alaska[41]
2. Arizona[42]
3. Colorado[43]
4. Delaware[44]
5. Florida[45]
6. Illinois[46]
7. Indiana[47]
8. Kentucky[48]
9. Michigan[49]
10. Minnesota[50]
11. Missouri[51]
12. Nevada[52]
13. New Hampshire[53]
14. New Mexico[54]
15. New York[55]
16. North Carolina[56]

17. Ohio[57]

18. Rhode Island[58]

19. South Carolina[59]

20. South Dakota[60]

21. Tennessee[61]

22. Texas[62]

23. Virginia[63]

24. Washington

25. Wisconsin[64]

26. Wyoming[65]

O. State Death Taxes. Even if the federal estate tax is repealed, many states will have a state death tax. In addition, Connecticut has a state gift tax. Planning will have to be done for residents of states with a state death tax and non-residents with property subject to tax in a state with a state death tax.

1. Planning for individuals who reside in one of these states or who have property subject to a state tax is more complicated than planning for individuals who are not subject to separate state death taxes. The states that currently have a separate state death tax (and their thresholds for tax) are:

State	Type of Tax	2017 Estate Tax Filing Threshold
Connecticut	Stand-Alone Estate	$2,000,000
Delaware	Estate	$5,490,000
District of Columbia	Estate	$2,000,000
Hawaii	Stand-Alone Estate	$5,790,000
Illinois	Estate	$4,000,000
Iowa	Inheritance	
Kentucky	Inheritance	
Maine	Estate	$5,490,000
Maryland	Estate and Inheritance	$3,000,000
Massachusetts	Estate	$1,000,000
Minnesota	Estate	$1,800,000
Nebraska	County Inheritance	
New Jersey	Estate and Inheritance	$2,000,000
New York	Estate	$4,187,500*
Oregon	Estate	$1,000,000

State	Type of Tax	2017 Estate Tax Filing Threshold
Pennsylvania	Inheritance	
Rhode Island	Estate	$1,500,000
Vermont	Estate	$2,750,000
Washington	Stand-Alone Estate	$2,129,000

* As of April 1, 2016 and through March 31, 2017. From April 1, 2017 through December 31, 2018 the New York Exemption is $5,250,000.

2. The effective combined federal and state tax rate for those states that are decoupled from the current federal state death tax varies depending upon whether the state permits the taxpayer to take into account the federal deduction in calculating the state tax. Internal Revenue Code Section 2058 allows a deduction for the state tax in calculating the taxable estate, which generally resulted in an iterative (or algebraic) calculation. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective state and federal tax rates. The federal estate tax return (Form 706) was redesigned to accommodate the calculation of tax in such a state by providing a separate line 3a on page 1 for calculating a "tentative taxable estate" net of all deductions except state death taxes, a line 3b for separately deducting state death taxes, and a line 3c for the federal taxable estate (old line 3). The "tentative taxable estate" in effect was the taxable estate for calculating the state tax (but not the federal tax) in such a state.

3. As the following table shows, the marginal federal rate in 2017 is 33.6% or 34.5% depending on whether the state allows a deduction for the state tax itself.

Top Marginal Estate Tax Rates			
	Federal	**State**	**Total**
2017			
"Coupled" State	40%	0	40%
Ordinary "Decoupled" State	34.5%	13.8%	48.3%
"Decoupled" State/No Deduction	33.6%	16%	49.6%

4. The resulting loss of state revenue and state budgetary shortfalls may lead states that lack a state death tax to enact new state death tax legislation. Two states have already done this. In 2009, Delaware, which had lacked a state death tax since 2005, reinstated its state death tax. Hawaii did so in 2010. Vermont lowered the threshold for its state death tax in 2009. However, it should be noted that some states actually phased out or eliminated their state death taxes at different points. New Jersey has repealed its state estate tax, but not its inheritance tax as of January 1, 2018. These states included Virginia, Wisconsin, Kansas, Indiana and Oklahoma. Other states have increased their thresholds for state death

taxes. These states include Maine, Maryland, Minnesota, New York and Rhode Island.

5. Not all states that have a state death tax, as noted above, set the same threshold for the imposition of the tax or enacted consistent provisions concerning whether it would be possible to make an election to qualify a QTIP trust for a state marital deduction distinct from the federal election. The variation in state laws since the enactment of the 2001 Tax Act resulted in a dramatic increase in estate planning complexity for individuals domiciled or owning real or tangible personal property in states with a state death tax. Individuals have explored numerous techniques for dealing with state death taxes, such as change of domicile, creation of legal entities to hold real property and movables, and use of lifetime gifts.

6. The states with a separate state estate or inheritance tax that specifically permit a QTIP election are Illinois, Kentucky (for separate inheritance tax), Maine, Maryland, Massachusetts, Minnesota, New Jersey (only to the extent permitted to reduce federal death tax), Oregon, Pennsylvania (for separate inheritance tax), Rhode Island, and Tennessee (for separate inheritance tax).

7. Portability of the federal exclusion provides further planning options. A couple can avoid all estate tax at the first death by passing property to the survivor in a form that qualifies for the marital deduction. The estate of the first spouse to die can elect portability, giving the survivor $10,980,000 of exclusion in 2017.

   a. The failure to shelter property from state estate tax at the first death can increase overall state estate taxes. Currently, only Hawaii and Delaware follow portability at the state level.

   b. A common solution is to use a credit shelter trust for the state threshold amount and then elect portability for the unused exclusion of the first spouse to die.

8. In an era of a greater federal estate tax exemption, individuals in states with a state death tax still have plenty of opportunities to implement strategies that minimize the impact of state death taxes, through a combination of lifetime transfers, change in domicile, and deferral of payment of state taxes by use of state QTIP elections. But the planning is more difficult because of the separate rules often affecting state and federal taxation.

IV. The Future

A. No matter what happens with respect to the possible repeal of the estate tax, gift tax, and generation-skipping transfer tax in 2017 or later, much work will remain for all estate planners.

B. If Congress fails in any attempt to repeal the estate tax, the gift tax, or the generation-skipping transfer tax, then the work of estate planners will continue as now. Of course, Congress may amend one or more of the three taxes by, for example, increasing the exemption or lowering the rates.

C. If the estate tax is repealed (and presumably if the estate tax is repealed the generation-skipping transfer tax will be repealed), there will still be much work for all estate planners.

1. For several years after repeal, lawyers will have work to revise estate plans in light of the lack of an estate tax. This may mean changing beneficiaries, the amounts going to specific beneficiaries, or formulas for allocating property. It may also mean seeking to terminate or change the terms of various irrevocable techniques that were created for estate and gift tax avoidance reasons.

2. If the estate is replaced with a capital gains tax at death, planning will have to account for the imposition of that tax.

3. If there is a carryover basis regime, work will be necessary to account for this.

4. If the gift tax is retained in any repeal of the estate and generation-skipping transfer taxes, planning will have to be done to avoid the gift tax.

5. Planning for estate taxes will still continue in those states with a state death tax.

6. The number of trusts and the value of the assets in trust will likely increase since estate taxes do not have to be paid at death and possibly gift taxes will not have to be paid on lifetime transfers.

7. Insurance will still be used for income replacement, the payment of capital gains tax at death, insuring that beneficiaries receive a minimum amount at the death of one or more insureds, funding business strategies such as buy-sell agreements, or for investment. Private placement insurance may become more popular as a form of investment if there is carryover basis or a capital gains tax at death.

8. The advice and counsel of estate planning professionals, no matter what the discipline will still be needed in areas such as:

a. Creditor Protection

b. Assert Protection

c. Business Planning

d. Income Tax Planning

e. Elder Law Issues

f. Retirement Benefits

g. Charitable Planning

h. Insurance Planning

D. While change can be disruptive, even if the estate tax is repealed, the future is bright for those estate planners who are willing to adapt and go after the immense amounts of work that will still be there.

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[2] www.donaldjtrump.com

[3] Ronald D. Aucutt. "Top Ten" Estate Planning and Estate Tax Developments of 2016.

[4] See Angela M. Vallario, Death by a Thousand Cuts: The Rule Against Perpetuities, 25 J. Legis. 141 & n.1 (1999) (citing John Chipman Gray, The Rule Against Perpetuities 191 (4th ed. 1942)).

[5] Florida Stat. Ann. § 689.225(2)(f). This provision is valid for all trusts created after December 31, 2000. For older trusts, the previous perpetuities period of 90 years remains effective.

[6] Wash. Rev. Code § 11.98.130. This provision is applicable to any irrevocable trust with an effective date on or after January 1, 2002. Unless the trust instrument otherwise provides, this provision does not apply to any irrevocable trust with an earlier effective date or any revocable or testamentary trust with an effective date on or after January 1, 2002 if at all times after the date of enactment the creator of the trust was not competent to revoke, amend or modify the will or trust instrument.

[7] Utah Statutes § 75.2-1203.

[8] Wy. ST. § 34-1-3-139(b).

[9] Nev. Rev. Statutes § 111.031.

[10] Col. Rev. Statutes § 15-11-1102.5 (1).

[11] Tenn. Code § 66-1-202 (f).

[12] See Alaska Stat. §34.27.075 (West 2000) ("The common law rule against perpetuities does not apply in this state"); Idaho Code §55-111 (West 2000) ("there shall be no rule against perpetuities applicable to real or personal property"); Kentucky Rev. Stat, ch. 381, § 224 ("An interest created in real or personal property shall not be void by reason of any rule against perpetuities, whether the common law rule or otherwise. The common law rule against perpetuities shall not be in force in this Commonwealth); N.J. Stat. Ann. § 46:2F-9 (West 2000) ("No interest created in real or personal property shall be void by reason of any rule against perpetuities, whether the common law rule or otherwise. The common law rule against perpetuities shall not be in force in this State"); R.I. Gen. Laws § 34-11-38 (West 2000) ("The common law rule against perpetuities shall no longer be deemed in force and/or of any effect in this state"); S.D. Codified Laws § 43-5-8 (West 2000) ("The common-law rule against perpetuities is not in force in this state"); Wis. Stat. Ann. §700.16(5) (West 2000) ("The common-law rule against perpetuities is not in force in this state"). Pennsylvania Senate Bill 660 (signed on July 7, 2006), amending Pennsylvania Consolidated Statutes Title 20, § 6104.

[13] Idaho's statute provides that "no trust heretofore or hereafter created, either testamentary or inter vivos, shall be declared void [under the Rule]. . ." Idaho Code §55-111. South Dakota's statute provides: "If no action or proceeding has been instituted by July 1, 1984, to declare void any instrument which existed prior to July 1, 1983 under the provisions of this chapter as it existed prior to July 1, 1983, then all such instruments shall be interpreted

under this chapter 43-5." S.D. Codified Laws §43-5-9. Wisconsin's statute provides that it "applies to interests in property in existence on July 1, 1971, and to interests in property created after such date." Wis. Stat. Ann. §700.25.

[14] New Jersey's statute provides that the abolishment legislation applies to future property interests or powers of appointment created on or after 7/9/99 or created before 7/9/99 pursuant to the laws of a state that does not enforce the Rule and to which, after 7/9/99, New Jersey law is made applicable by such means as a transfer of the trust situs to New Jersey or a change in the law governing a trust instrument to New Jersey law. See N.J. Stat. Ann. §46:2F-11(a).

[15] Alaska's statute provides that the statutory rule against perpetuities contained in Alaska Statutes §34.27.051 applies to trust instruments executed on or after April 2, 1997 if the trust instrument creates a nonvested property interest subject to the exercise of a power of appointment that creates a new or successive power of appointment. See Alaska Stat. §34.27.070. Neither §34.27.051 nor §37.27.070 discusses nonvested property interests that are not subject to such powers of appointment. Therefore, it appears to be unclear whether the repeal of the Rule applies retroactively to all nonvested property interests. Rhode Island's statute provides that the Rule is no longer in force provided that "the provisions of this section shall not be construed to invalidate or modify the terms of any interest which would have been valid prior to the effective date of this act [1999]. . ." R.I. Gen. Laws §34-11-38.

[16] N.C. Gen. Stat. §41-23.

[17] Brown Brothers Harriman Trust v. Benson, 202 N.C. App. 283 (2010), appeals denied by North Carolina Supreme Court, 703 S.E. 2d 157 (2010).

[18] Hawaii Rev. Stat. §525-4(6).

[19] See Del. Code Ann. tit. 25, §503(a) (West 2000) ("No interest created in real property held in trust shall be void by reason of the common law rule against perpetuities and no interest created in personal property held in trust shall be void by reason of any rule against perpetuities, whether the common law rule or otherwise").

[20] See id. at §503(b).

[21] Mich. Comp. Laws §§ 554.91-94.

[22] Richard W. Nenno. "Let My Trustees Go! Planning to Minimize or Avoid State Income Taxes on Trusts." Proceedings of the 2012 Heckerling Institute on Estate Planning. p. 15-7. (Hereafter "Nenno"). This paper is the best single source on the income taxation of trusts and estates from a state perspective.

[23] Nenno, p. 15-8.

[24] Nenno, p. 15-8.

[25] Nenno, p. 15-9.

[26] Nenno, p. 15-9.

[27] Nenno, p. 15-9.

[28] Va Code Ann. § 58.1-302.

[29] 23 VAC 10-115-10.

[30] Cal Rev and Tax Code § 17742.

[31] See, e.g., Private Letter Rulings 201510001–201510008 (issued October 10, 2014; released March 6, 2015).

[32] N.Y. Tax Law § 605(b)(3)(A)–(C).

[33] N.Y. Tax Law § 605(b)(3)(D).

[34] N.Y. Tax Law § 612(b)(41) (McKinney).

[35] Bernard Kliska, *Planning for Business Succession*, CHI. BAR ASS'N, Apr. 16, 1996, at 1.

[36] *Id.* at 1.

[37] MASSMUTUAL, AMERICAN FAMILY BUSINESS SURVEY 7 (2007).

[38] MASSMUTUAL, AMERICAN FAMILY BUSINESS SURVEY 7 (2007).

[39] Phipps v. Palm Beach Trust Co., 196 So. 299 (Fla. 1940).

[40] 466 Mass. 92 (2013)

[41] Alaska Stat. § 13.36.157

[42] Ariz. Rev. Stat. §14-10819

[43] Col. Rev. Stat. §15-16-901 et. seq.

[44] Del. Code tit 12 § 3528

[45] Fla. Stat. § 736.04117

[46] 760 ILCS 5/16.4

[47] Ind. Code § 30-4-3-6

[48] KRS § 286.175

[49] MCL § 556.115a

[50] Minn. Stat § 502.85

[51] Mo. Rev. Stat. § 456.4-419
[52] Nev. Stat. § 136.037
[53] N.H. Rev. Stat. § 564-B:4-418
[54] Uniform Decanting Act, passed March 8, 2016 and effective January 1, 2017
[55] N.Y. EPTL § 10-6.6(b).
[56] N.C. Gen. Stat. § 36C-8-816.1
[57] Ohio Rev. Code § 5808.18
[58] HB7664
[59] S. Car. Stat § 62-7-816A
[60] S.D. Codified Laws § 55-2-15
[61] Tenn. Code § 35-15-816(b)(27)
[62] Texas Property Code §§ 112.071-112.087
[63] VA Code § 64.2-778.1
[64] Wis. Trust Code § 701.0418
[65] Wy. Stat. § 4-10-816(a) (xxviii)

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RECENT DEVELOPMENTS*

LEGISLATIVE PROPOSALS AND IRS GUIDANCE

1. Impact of the 2016 Federal Election on the Transfer Tax System

November 2016 federal election could have dramatic impact on estate, gift, and generation-skipping taxes

Impact of 2016 Federal Election. The most conspicuous development of 2016, affecting many areas of public policy including tax policy, is clearly the 2016 election, most notably the election of President Donald Trump and the retention of Republican control of the Senate. With the continued Republican control of the House, the Republicans have complete control of the executive and legislative branches of the federal government.

While tax reform is discussed almost every four years, and it is harder to do than it sometimes sounds, the talk this year is serious. With control of both Houses of Congress barely changed and the surprising capture of the White House, Republican leadership will be under enormous pressure to produce very significant tax legislation in 2017 by the August recess because now they can, and because, with no excuses left, they must. The June 2016 Blueprint, which Ways and Means Chairman Kevin Brady has described as 80 percent in sync with President Trump's campaign's plan and to which the President's transition team seems largely willing to defer, will be the likely vehicle.

It is worth noting that the United States has had four estate taxes in its history;

The Stamp Act of 1797 imposed a federal stamp on wills in probate to pay off debts incurred during the undeclared naval war with France in 1797. Congress repealed the Stamp Act in 1804.

The Tax Act of 1862 imposed a federal inheritance tax. Congress increased the rates and added a succession tax in 1864. The tax was repealed in 1870.

The War Revenue Act of 1898 to help pay for the costs of the Spanish-American War imposed a tax, but was repealed shortly after enactment.

The modern estate tax was enacted in 1916.

*This outline is based on materials prepared by McGuireWoods LLP lawyers Ronald D. Aucutt, W. Birch Douglass III, Andrea C. Chomakos, Charles D. Fox IV and Stephen W. Murphy.

The Possibility of Changes in the Estate Tax. The Donald J. Trump for President Website has the following text on the website about the estate tax:

> "The Trump Plan will repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into a private charity established by the decedent or the decedent's relatives will be disallowed."

In September 2016, Candidate Trump said of his proposal, "It ends the death tax. It's a double taxation, a lot of families go through hell over the death tax."

It is unclear from the current Trump Proposal whether the gift tax and the generation-skipping transfer tax will be repealed and whether the proposal refers to a capital gains tax on appreciated assets at death or carryover basis in some modified form as was proposed in the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") was enacted for 2010 when the estate was repealed.

The Republican leadership of the House of Representatives issued "A 21st Century Tax System Built for Growth" on June 23, 2016 as a "Blueprint" to outline how it wishes to reform the current income tax system. The Blueprint noted upfront that it does not include a value-added tax (VAT), a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system. It calls for the repeal of the estate and generation-skipping taxes. The Blueprint is discussed in detail in item 2.

As can be seen above, it is unclear as what form, if any, repeal or changes in the estate, gift, and generation-skipping transfer tax will take. Some questions are:

> Will all three taxes be repealed?
>
> Will the gift tax be retained as it was in the 2001 Tax Act? The reason for the retention of the gift tax in the 2001 Tax Act was to prevent United States citizens from making gifts of highly appreciated assets to family members or others in jurisdictions that have no income tax or gift tax. The recipients would then sell the highly appreciated assets and pay no capital gains or other taxes. Then the recipients would gift the proceeds back to the original United States donors.
>
> Will there be a step up in basis for assets passing at a decedent's death?
>
> Will a capital gains tax be imposed at death? If so, will there be exemptions or a threshold before the capital gains tax will be imposed?
>
> Will there be carryover basis for appreciated assets at death? If so, will there be a modified carryover basis regime as there was in the 2001 Tax Act? Under the 2001 Tax Act, a decedent's executor could allocate a basis increase of up to $1.3 million, regardless of the recipient of the property. An additional $3 million of basis could be allocated to property owned by the decedent at death that was transferred to the decedent's surviving spouse either as an outright gift or as qualified terminable interest property ("QTIP").

Various statements on possible repeal have been made by supporters of repeal.

> "It will still be a heavy lift but not insurmountable as it has been with Obama in office. Trump made repeal of the death tax a key tenet of his tax reform proposal, and we look forward to working with him to see it through."
>
> - Palmer Schoening, President of the Family Business Council.
>
> "I look forward to working with President-elect Trump on legislation to permanently bury the death tax once and for all. For too long, this tax has threatened family owned businesses—including women and minority-owned businesses—from being passed down to their children and grandchildren. It's time to move forward with pro-growth reform that fully repeals it with a tax code built for growth."
>
> - Kevin Brady, Chair of the House Ways and Means Committee, November 21, 2016.
>
>   (The Ways and Means Committee is the primary committee in the House of Representatives that will deal with tax reform and changes in the tax laws.)

"The death tax on family farms, small businesses, ranches and estates has crippled hard-working families for far too long. It ought to be repealed, plain and simple."

- Orrin Hatch, Chair of the Senate Finance Committee, November 21, 2016.

  (The Finance Committee is the primary committee in the Senate that will deal with tax reform and changes in the tax laws.)

Legislative Framework for Repeal. The legislative framework for tax reform remains unclear. It might be assumed that the Republican leadership would want some Democratic votes. After all, they made such a big deal of the enactment of the Affordable Care Act without a single Republican vote. But memories are short. In any event, it is not clear that the Republican leadership would want Democratic votes so much that they would try to get 60 total votes in the Senate to "call the question" on regular legislation. A few bipartisan votes are fine, but not so desirable that the leadership would really want to "negotiate" or to concede much to get them. That leaves the process of "budget reconciliation" as the likely process, especially for a clearly fiscal agenda like tax legislation. But while "reconciliation" famously does not need 60 votes in the Senate, the 60-vote requirement cannot be avoided just be using the label "reconciliation." There must first be a "budget resolution," setting out broad guidelines for the inputs of multiple committees that will be brought together and "reconciled." If that budget resolution is not passed by March, or perhaps April, tax reform will be behind schedule.

Budget reconciliation can be used only once a year. It is limited to fiscal matters. And it is limited further by constraints like the impropriety of affecting budget outcomes beyond an arbitrary budget window—most recently ten years. We all remember (or have heard about) the peculiar one-year "repeal" of the estate tax that was enacted in budget reconciliation in 2001. Sunsets are not inevitable. There are workarounds. The Taxpayer Relief Act of 1997 was also enacted through budget reconciliation, with substantial permanent estate tax cuts. But both 1997

and 2001 presented much different fiscal environments. In June 2001, when the 2001 Tax Act was enacted—before 9/11, Afghanistan, and Iraq—budget surpluses of trillions of dollars were forecast for the coming decade. The 2001 Tax Act included only a modest one and one-third trillion dollars of tax cuts! Today the forecasts are only more deficits.

No one can currently state exactly what will happen with the estate, gift, and generation-skipping taxes. Some commentators have said that the estate tax will be repealed by Congress and that it is already dead.

Others believe that the estate tax may survive and point out:

> The technical paths to permanent repeal of the estate tax are complicated and maybe risky to Republicans (especially to the extent they need Democratic support).
>
> The unexpected surge of disillusioned middle-class voters that propelled President Trump to victory may not be very excited about the estate tax.
>
> The attractiveness of repeal even to traditional supporters may be blunted by the prospect of having to keep the gift tax, or having to deal with a scary new capital gain or basis regime, and attempts to "have it all" will cost still more and look still more greedy.
>
> Repeal of the estate tax in 2017, permanently or temporarily, would require political capital that the Republican leadership will probably decide to spend elsewhere. A compromise reduction of rates by 5 or 10 percent is possible, and even with high exemptions there might actually be some justification in tax policy for bringing transfer tax and income tax rates closer together. But that too would look expensive and possibly too greedy.

2. A 21st Century Tax System Built for Growth (June 23, 2016)

House Republican leadership issues "Blueprint" addressing changes to the tax system

The House Republican leadership issued this Blueprint in June 2016 to outline how it wishes to reform the current income tax system. The Blueprint noted upfront that it does not include a value-added tax (VAT), a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system.

According to the Blueprint, the new tax system will simplify and lower tax rates. It also will provide for reduced but progressive tax rates on capital gains, dividends, and interest income. In addition, the changes will significantly reduce the complexity and compliance burdens of the current system.

One integral part of this Blueprint is a new IRS that will be aligned with the new tax code. Under the Blueprint, the new IRS will be built for customer service. The new IRS will have a unit that will serve families and individuals and a separate unit that will serve businesses.

The Blueprint notes that, at the beginning of the 114th Congress, House Republicans approved a rule requiring the Joint Committee on Taxation to estimate the macroeconomic effects of major tax legislation and to include changes in Federal revenues resulting from changes in the size of the economy to be included as part of the official revenue estimate. This means that dynamic scoring, as opposed to static scoring will be used.

The Blueprint assumes that the substantial tax increases enacted as part of the Obamacare law will be repealed.

Highlights

This Blueprint seeks to simplify, flatten, and lower tax rates for families and individuals and to provide reduced and progressive tax rates on capital gains, dividends and interest income, to encourage savings and investment. This Blueprint will eliminate the alternative minimum tax. The Blueprint also will eliminate the estate tax and the generation-skipping transfer tax "so that the death of a family member or loved one no longer will be a taxable event."

Individual Income Tax Rates

The Blueprint consolidates the current seven tax brackets to three brackets and lowers the top individual income tax rate to 33 percent. Going forward, these income tax brackets will be indexed for inflation.

INDIVIDUAL INCOME TAX BRACKETS UNDER THE BLUEPRINT

Current Law	Blueprint
10%	0%/12%*
15%	
25%	25%
28%	
33%	33%
35%	
39.6%	

***** The new standard deduction is larger than the current-law standard deduction and personal exemptions combined. This, in effect, creates a larger 0 percent bracket. As a result, taxpayers who are currently in the 10 percent bracket always will pay lower taxes than under current law.***

The Blueprint creates a new business tax rate for small businesses that are organized as sole proprietorships or pass-through entities, which means that small business income will be subject to a maximum tax rate of 25 percent on small business income.

Individual Alternative Minimum Tax

This Blueprint repeals the individual AMT.

Income from Savings and Investment

The Blueprint provides for reduced tax on investment income. Families and individuals will be able to deduct 50 percent of their net capital gains, dividends, and interest income, leading to basic rates of 6 percent, 12.5 percent, and 16.5 percent on such investment income depending on the individual's tax bracket. The Blueprint also includes interest income within the reduced tax on investment income, as part of the move in the direction of a cash-flow tax.

Consolidation of Deductions

The Blueprint consolidates five basic family tax deductions and credits—the basic standard deduction, additional standard deduction, personal exemption for taxpayer and spouse, the personal exemptions for children and dependents, and the child tax credit into one deduction and one credit—a larger standard deduction and an enhanced child and dependent tax credit.

Earned Income Tax Credit

The Blueprint will continue the earned income tax credit (EITC).

Simplification of Tax Benefits for Higher Education

This Blueprint will simplify the current array of tax benefits for families looking to make education more affordable for their children by simplifying and consolidating the current-law provisions to provide a package of higher education tax benefits that will cover both college and vocational training programs, including a savings incentive, such as 529 plans, and tax relief targeted at helping low- and middle-income families with the costs of higher education, such as the American Opportunity Tax Credit.

Individual Exclusions and Deductions

The Blueprint reflects the elimination of all itemized deductions except the mortgage interest deduction and the charitable contribution deduction.

Retirement Savings

The Blueprint appears to continue current incentives for savings such as Individual Retirement Accounts (IRAs). It also states that Committee on Ways and Means will explore the creation of more general savings vehicles, using as a model the existing retirement accounts. It may look at Universal Savings Accounts. These are accounts to which individuals could contribute cash and over which they would have full control of investment decisions. Account holders could withdraw both contributions and earnings at any time, and for any reason, without penalty.

Generation-Skipping Transfer Taxes

This Blueprint repeals the estate and generation-skipping transfer taxes which "will eliminate the Death Tax, which can result in double, and potentially even triple, taxation on small businesses and family farms."

3. 2016–2017 Priority Guidance Plan (August 15, 2016)

Treasury Department and the Internal Revenue Service release their 2016–17 priority guidance plan

The annual priority guidance plan contains the following 12 items under the heading of "Gifts and Estates and Trusts" for the years 2016 to 2017:

1. Guidance on qualified contingencies of charitable remainder annuity trusts under Section 664.
2. Guidance on definition of income for spousal support trusts under Section 682. [NEW]
3. Guidance on basis of grantor trust assets at death under Section 1014.
4. Final regulations under Sections 1014(f) and 6035 regarding consistent basis reporting between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016. [NEW]
5. Revenue procedure under Section 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability. Revenue Procedure 2016-49, 2016-49 2016-42 I.R.B. 1 to address this was issued on September 27, 2016.
6. Guidance on the valuation of promissory notes for transfer tax purposes under Sections 2031, 2033, 2512, and 7872.
7. Final regulations under Section 2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.
8. Guidance under Section 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
9. Guidance on the gift tax effect of defined value formula clauses under Sections 2512 and 2511.
10. Guidance under Sections 2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts. [NEW]

11. Regulations under Section 2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships. Proposed regulations were issued on August 2, 2016.
12. Guidance under Section 2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

The items deleted from the 2015-16 Priority Guidance Plan are:

1. Final regulations under Section 1014 regarding uniform basis of charitable remainder trusts. Proposed regulations were published on January 17, 2014. Final regulations were issued on August 11, 2015.
2. Regulations under Section 2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP.
3. Final regulations under Section 2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.

4. Revenue Procedure 2016-55, 2016-139 I.R.B. (October 25, 2016)

IRS provides the 2017 inflation adjusted amounts for tax exemptions, deductions, brackets, and other items

This Revenue Procedure provides the 2017 inflation adjusted item amounts for tax exemptions, deductions, brackets and other tax items. Selected adjusted income and gift and estate tax numbers are:

- The gift tax annual exclusion remains at $14,000.
- The estate tax applicable exclusion amount is increased because of the inflation adjustment to $5,490,000.
- For an estate of a decedent dying in 2017, the aggregate decrease in the value of qualified property for which a special use valuation election is made under Section 2032A cannot exceed $1,120,000.
- The annual exclusion for gifts to non-citizen spouses is increased to $149,000.
- Recipients of gifts from certain foreign persons must report these gifts if the aggregate value of the gifts received in 2015 exceeds $15,799.
- For estates making the Section 6166 election to defer estate tax on closely held businesses and pay the tax in installments, the dollar amount used to determine the "2 percent portion"(for purposes of calculating the interest owed) is $1,490,000.

- The top 39.6% income tax rate hits at the following amounts for the different categories of taxpayers:

Married Individuals Filing Jointly	$470,700
Heads of Households	$444,550
Unmarried Individuals	$418,400
Married Individuals Filing Separately	$235,350
Estate and Trusts	$12,500

- The "Kiddie Tax" exemption remains at $1,050.

5. Retirement Enhancement and Savings Bill of 2016 (September 21, 2016)

Senate Finance Committee approves package of retirement reforms to improve the retirement system

The Senate Finance Committee on September 21, 2016 by a 26-0 vote approved the Retirement Enhancement and Savings Bill of 2016. The Bill consists of various provisions that were included as part of a collaborative effort of many members of the Senate Finance Committee.

One of the important proposals is to change the post-death required minimum distribution rules applicable to defined contribution plans and IRAs. The proposal applies to the extent that the amount of an individual's aggregate account balances under all IRAs and defined contribution plans, determined as of the date of death, exceeds $450,000 indexed for inflation. Thus, if an individual dies with aggregate account balances of $600,000 as of the date of death, present law will apply to the first $450,000 and the proposed changes will apply to the remaining $150,000. If the individual has more than one beneficiary, the portion of the amount above $150,000 that is subject to the proposal with respect to each beneficiary is the amount that is the same proportion of the excess as the portion of the total to which the individual is entitled. The proposal does not apply for determining after death required minimum distributions from defined benefit plans.

Under the proposal, the five-year rule will be the general rule for all distributions after death except and unless the designated beneficiary is an eligible beneficiary. Eligible beneficiaries include surviving spouses, disabled beneficiaries, chronically ill individuals, and an individual who is not more than 10 years younger than the account holder or is a minor child. With respect to a minor child, the calculation of the minimum required distribution under the exception is only allowed through the year in which the child reaches age 18.

Basically under this rule, the entire benefit over $450,000 to ineligible beneficiaries is required to be distributed within five years following the death of the participant. The new rules will be effective for participants who die after September 30, 2016 if the legislation is passed and becomes law.

6. In re Estate of Vose, 390 P.3d 238 (Okla. January 17, 2017)

Oklahoma Supreme Court affirms lower court decision compelling personal representative to file estate tax return making the portability election

In this case, the Oklahoma Supreme Court upheld the decision of the lower court to force the executor to file an estate tax return on which the portability election would be made. This was in spite of the fact that the surviving spouse and the deceased spouse signed a prenuptial agreement waiving all claims and rights. With respect to the prenuptial agreement issue, the court observed that a valid waiver requires full knowledge of the rights intended to be waived and that Section 2010 was enacted after the prenuptial agreement was signed and gave the surviving spouse a potential interest in part of the deceased spouse's estate. The court said that the deceased spouse's unused exemption amount is not the same as property acquired by one party during the course of the marriage according to the laws in effect when the agreement was made.

In addition, the court emphasized that the personal representative had a fiduciary relationship to all parties having an interest in the estate and that the surviving spouse was the only person who had an interest in and the ability to use the Deceased Spouse's Unused Exemption, or DSUE, amount. The personal representative had argued that the estate should be able to demand consideration of the surviving spouse, but the court instead focused on the loss to the surviving spouse if the portability election was not made and the surviving spouse's agreement to pay any costs associated with filing the return.

7. Letter Rulings on Extension of Time to Make Portability Election

Extension of time to make portability election permitted

Numerous letter rulings (too numerous to list) have been, and continue to be, issued on the same fact pattern. Decedent's estate was less than the applicable exclusion amount in the year of decedent's death. Decedent's estate failed to file a federal estate tax return to make the portability election and discovered its failure to elect portability after the due date for making the election. In each letter ruling, the IRS determined that the requirements of Treas. Reg. § 301.9100-3 for granting an extension of time to make an election were met. Under this regulation, an extension of time will be granted if a taxpayer is deemed to have acted reasonably and in good faith. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer if the tax professional failed to make or advise the taxpayer to make the election. In 2017, the standard fee for a letter ruling requiring an extension of time under Treas. Reg. § 301.9100-3 is $10,000. Revenue Procedure 2017-1, 2017-1 IRB 1.

8. Revenue Procedure 2017-34, 2017-26 I.R.B. 1282 (June 9, 2017)

IRS provides a simplified method for non-taxable estates of first spouse to die to obtain an extension of time to make a portability election

One of the more vexing challenges for executors of the estate of the first spouse to die since the introduction of portability in 2011 has been meeting the requirement of Section 2010(c) that the estate much make the portability election on a timely filed estate tax return, even if the estate of the first spouse to die is below the threshold for filing an estate tax return.

This revenue procedure provides a simplified method for certain taxpayers to obtain an extension of time under Treas. Reg. § 301.9100-3 to make a portability election under Section 2010. A portability election allows the unused exclusion amount of the first spouse to die to be available to the surviving spouse for subsequent transfers during the life of the surviving spouse or at the death of the surviving spouse. The simplified method provided in this revenue procedure is intended to be used in lieu of the letter ruling process. No user fee is required for submissions under this revenue procedure.

Previously, the IRS published Rev. Proc. 2014-18, 2014-7 IRB 513, which provided a simplified method for obtaining an extension of time under Treas. Reg. § 301.9100-3 to make a portability election if the estate of the first spouse to die was not required to file an estate tax return and if the decedent was survived by a spouse. This simplified method was available only on or before December 31, 2014. Since December 31, 2014, the IRS has issued numerous, almost identical letter rulings under Treas. Reg. § 301.9100-3 granting an extension of time to elect portability in situations in which the estate of the first spouse to die was not required to file an estate tax return. Many of these ruling requests involved estates of decedents that discovered the failure to elect portability not long after the due date for filing an estate tax return to elect portability. Other requests have involved estates of decedents with a date of death in the first years after the enactment of the portability election provisions, in which the executor did not know about the need to file a return to elect portability or did not discover the failure to elect portability until many years later, often after the death of the surviving spouse.

The IRS determined that the number of ruling requests for an extension of time to elect portability indicated the need for continued relief for estates of decedents who otherwise would not have to file a federal estate tax return. In addition, the number of ruling requests had placed a significant burden on the IRS.

This revenue procedure provides a simplified method to obtain an extension of time to elect portability that is available to estates of the first spouse to die which have no filing requirement for a period until the later of January 2, 2018 or the second anniversary of the decedent's date of death. An estate seeking to elect portability after the second anniversary of decedent's death may continue to do so by requesting a letter ruling.

This relief provided by this revenue procedure is only available if the decedent is survived by a spouse who died after December 31, 2010 and was a citizen or resident of the United States on the date of death. To meet the requirements of relief under this revenue procedure, the executor must file a complete and properly prepared Form 706, federal estate tax return, on or before the

later of January 2, 2018 or the second annual anniversary of decedent's date of death. At the top of the Form 706, the estate must state that the return is "FILED PURSUANT TO REV. PROC. 2017–34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)." A Form 706 filed in accordance with this revenue procedure will be considered to have been filed timely.

As noted above, there will be no user fee for an estate tax return filed pursuant to this revenue procedure.

9. Notice 2017-12, 2017-5 I.R.B 742 (January 6, 2017)

IRS provides guidance on methods available to confirm closing of the estate tax return examination

Prior to June 1, 2015, the IRS issued estate tax closing letters for every estate tax return filed. However, the IRS changed its policies for returns filed on or after June 1, 2015. The IRS will now issue a closing letter for an estate only if the estate requests such a closing letter. The request of an estate for a closing letter is to be made four months after the filing of the estate tax return.

The IRS in this Notice stated that it had previously announced that it would no longer issue estate tax closing letters as a matter of course and noted that different state and local agencies have come to rely upon closing letters for confirmation that the IRS has closed its examination of the estate. In the absence of a closing letter, an account transcript, which is a computer generated report reflecting current account information can be relied upon a substitute for the closing letter. However, the IRS noted that a closing letter is not equal to a closing agreement and that under certain circumstances, the IRS can reopen the examination. A taxpayer can confirm the closing of the IRS's examination of an estate tax return by requesting a transcript of the account. If the account transcript contains a transaction code of "421," this, similar to the receipt of an estate tax closing letter, will confirm the closing of the IRS's examination of the return.

10. Notice 2017-15, 2017-6 I.R.B. 783 (January 17, 2017)

Notice provides procedures for retroactive relief for same sex partners with respect to applicable exclusion amounts and GST exemption

The purpose of this notice is to provide guidance on the application of the decision in United States v. Windsor, 570 U.S. ___, 133 S. Ct. 2675 (2013) with respect to the use of the applicable exclusion amount and the GST exemption as they relate to certain gifts, bequests and generation-skipping transfers by or to same sex spouses. In particular, the Notice provides special administrative procedures allowing certain taxpayers and the executors of the estates of certain taxpayers to recalculate a taxpayer's remaining applicable exclusion amount and remaining GST exemption to the extent an allocation of that exclusion or exemption was made to certain transfers while the taxpayer was married to a person of the same sex.

With respect to the applicable exclusion amount as applied to a transfers between spouses that did not qualify for the federal estate or gift tax marital deduction at the time of the transfers because of the application of the Defense Marriage Act, taxpayers will be permitted to establish that the transfers qualify for the estate or gift tax marital deduction and can recover the applicable exclusion amount previously applied on a return by reason of such a transfer even if the limitations applicable to that return for claiming a credit or refund of tax has expired. If, however, qualification for the reverse QTIP election to permit allocation of the GST Exemption by the first spouse would require a QTIP Trust or a Qualified Domestic Trust, the taxpayers will have to request relief pursuant to Treas. Reg. § 301.9100-3.

With respect to a taxpayer's GST exemption that was allocated to transfers made, prior to the recognition of same sex marriages for federal tax purposes, to or for the benefit of one or more persons in a same sex marriage and, or any other persons who generation assignment is determined with reference to a same sex spouse, certain exemption allocations to transfers to persons now recognized to be non-skip persons will be deemed void. Accordingly, taxpayers who made such a transfer will be permitted to recalculate the amount of the remaining GST exemption.

MARITAL DEDUCTION

11. Letter Ruling 201641018 (Issued July 7, 2016; Released August 7, 2016)

IRS permits extension of time to make QTIP Election

Upon Decedent's death, the surviving spouse, as executor of Decedent's estate, determined that the fair market value of the estate was less than the available exclusion amount for Decedent. The spouse did file a federal estate tax return to make the portability election under Section 2012(c), since the spouse believed that the value of the estate was not sufficient to fund the marital trusts. As a result, a QTIP election was not made on the filed Form 706.

On the Form 706, the spouse reported an incorrect value for an item of tangible personal property. After an additional appraisal and subsequent sale of the item of tangible personal property, the spouse realized that the Form 706 was inaccurate. Based on the valuation of the tangible property, the marital trusts were required to be funded. The spouse requested an extension of time to make the QTIP election.

Under Treas. Reg. § 301.9100, the IRS may grant a reasonable extension of time if the taxpayer demonstrates that the taxpayers acted reasonably and in good faith and granting relief will not prejudice the interest of the government. The IRS ruled the death standard had been met and granted the extension of time to make the QTIP election.

12. Letter Ruling 201714020 (Issued December 6, 2016; Released April 7, 2017)

Decedent's estate qualifies for an extension of time to make a QTIP election

Upon the decedent's death, a Marital Trust was established for the benefit of the spouse. The Marital Trust contained the necessary requirements for a QTIP trust. The spouse was entitled to the net income of the Marital Trust at least quarterly. The trustee could pay to the spouse discretionary distributions of the principal as necessary to support and maintain the spouse in the standard of living to which the spouse was accustomed during the decedent's lifetime. Upon the spouse's death, the Marital Trust property was to be distributed to the decedent's then living descendants. The spouse had a testamentary limited power of appointment to descendants of the decedent.

The spouse and a child were the co-executors of the decedent's estate. They engaged a CPA to prepare the estate tax return. On Schedule M of the estate tax return, the property passing to the Marital Trust was listed as property other than QTIP property. Consequently, no QTIP election was made.

The estate requested an extension of time under Treas. Reg. §§ 301.9100-1 and 301.9100-3 to make a QTIP election. Requests for relief under Treas. Reg. § 301.9100-3 will be granted when a taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government.

The IRS also noted that a taxpayer is deemed to have acted reasonably and in good faith when the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

The IRS concluded that the requirements of Treas. Reg. § 301.9100-3 were satisfied and the estate was granted an extension of time to make the QTIP election with respect to the Marital Trust.

13. Letter Ruling 201640006 (Issued June 21, 2016; Released September 30, 2016)

IRS permits an extension of time to notify the IRS that spouse had become a United States citizen

Decedent was survived by his spouse who was not a United States citizen. The spouse established a qualified domestic trust and funded the trust with assets that would have passed outright to qualify the property for the estate tax marital deduction. Decedent's estate timely filed the federal estate tax return and the executor made an election to treat the trust as a qualified domestic trust.

Subsequently, the spouse became a United States citizen. Subsequent to Decedent's death, accountant was engaged to assist in preparing the necessary tax returns. The accountant never advised the trustees of the need to file a final Form 706-QDT upon spouse becoming a United States citizen. The spouse then died. The trustees then became aware of the requirement to file a final Form 706-QDT by April 15th of the year after the year in which the spouse obtained citizenship.

The trustees requested an extension of time under Treas. Reg. § 301.9100-3. Requests for relief under this regulation will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interest of the government. A taxpayer is deemed to have acted reasonably and in good faith that the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make an election.

Based on the facts submitted, the IRS concluded that the requirements of Treas. Reg. § 301.9100-3 were satisfied and an extension of time was granted.

14. Revenue Procedure 2016-49, 2016-42 I.R.B. 1 (September 27, 2016)

QTIP election permitted in connection with portability election even though QTIP election was unnecessary to reduce estate tax to zero

One item on the IRS' 2016-2017 Priority Guidance Plan (August 15, 2016) was "Revenue Procedure under Section 2010(c) regarding the validity of QTIP election on an estate tax return filed only to elect portability." When the final regulations on portability were issued, on June 12, 2015 (TD 9725, 2015-25 I.R.B. 1122), they did not address the issue of the ability of the estate of the first spouse to die to make a QTIP election to qualify property passing to the surviving spouse and reduce the taxable estate of the first spouse to die and thereby maximize the amount of the unused exclusion available to the decedent's surviving spouse as a result of making a portability election.

Since portability of the unused exemption of the first spouse to die became effective in 2011, estate planners have been concerned about the possible impact of Revenue Procedure 2001-38, 2001-24 I.R.B. 1335 which provided a procedure by which the IRS will disregard and treat as a nullity for estate, gift, and generation-skipping tax purposes the QTIP election made in cases in which the election was unnecessary to reduce the estate tax liability to zero. When Revenue Procedure 2001-38 was issued, it provided relief to the surviving spouse of the decedent whose estate received no benefit from an unnecessary QTIP election (such as when a QTIP election was mistakenly made for a credit shelter trust which, if effective, would cause the inclusion of the assets of the credit shelter trust in the surviving spouse's estate). The advent of portability in 2011 brought into question, however, the nullification of unnecessary QTIP elections in Revenue Procedure 2001-38. The issue was whether a decedent's estate could make an otherwise unnecessary QTIP election to maximize the available unused exclusion amount of the first spouse to die that could be transferred to the surviving spouse.

This Revenue Procedure modifies and supersedes Revenue Procedure 2001-38. It permits a QTIP election when the executor of the estate makes a portability election even if the amount of the unused exemption of the first spouse is zero based upon values as finally determined for federal estate tax purposes.

This Revenue Procedure also details the procedural requirements for relief to treat an unnecessary QTIP election as void by filing one of: (a) a supplemental estate tax return for the estate of a predeceased spouse; (b) a gift tax return for the surviving spouse; or (c) an estate tax return for the surviving spouse. The return filed must contain the notation at the top "filed pursuant to Revenue Procedure 2016-49." An explanation is to be attached and should include all relevant facts such as the value of the predeceased spouse's taxable estate without regard of the allowance of the marital deduction for the QTIP at issue compared to the applicable exclusion amount in affect for the year of the predeceased spouse's death. The explanation should state that the portability election was not made in the predeceased spouse's estate and include facts to support the statement. Evidence sufficient to establish that the QTIP election was unnecessary to reduce the estate tax liability to zero if the executor of the estate of the first spouse to die did not elect portability may include a copy of the predeceased spouse's estate tax return filed with the IRS or a copy of the IRS's transcript of the review of first spouse's estate tax return.

GIFTS

15. Karen S. True v. Commissioner, Tax Court Docket No. 21896-16 and H. A. True III v. Commissioner, Tax Court Docket No. 21897-16 (Petitions filed October 11, 2016)

IRS attacks use of Wandry clause in gift and sale of interests in a family business

In the True v. Commissioner case, Husband gave interests in a family business to one of his daughters. At the same time, he sold interests in the family business to his three children and a trust. Husband obtained appraisals from FMV which the court noted is a recognized and reputable national appraisal firm. Since Husband and Wife split the gift, any gift was considered made one-half by each spouse.

When the gifts of the interests in the family business were made to the daughter, the transfer agreement provided that if the value of the interests transferred to the daughter were determined to be worth more than $34,044,838 for federal gift tax purposes, then the interests owned by the daughter would be adjusted so that the value of the gift remained at $34,044,838 and the daughter would be treated as having purchased the ownership interests that were removed from the gift. Thus, the transfer documents utilized adjustment provisions to fix the value of the interests given to the daughter at a specific dollar value similar to the adjustment clause upheld by the Tax Court in Wandry v. Commissioner, T.C. Memo 2012-88 and with which decision the Service disagrees.

With respect to the interests that were sold to that daughter and the other two children and a trust, the transfer documents provided that if the interests sold were undervalued by FMV for federal gift tax purposes, the purchase price would be increased to reflect the fair market value as finally determined for gift tax purposes.

The IRS has alleged a gift tax deficiency of $16,591,418 by each of Husband and Wife. Husband and Wife have countered that the valuations are correct. However, if the transferred interests are determined to have a higher value, no gift should result because of the adjustment provisions contained in the transfer agreement. These two cases may help determine the future validity and usefulness of Wandry adjustment clauses.

16. Letter Ruling 20165005 (Issued August 28, 2016; Released December 9, 2016)

Favorable ruling on the formation of an incomplete gift non-grantor trust

This is another favorable ruling from the IRS on the formation of an incomplete non-grantor trust created by a grantor to benefit himself, his spouse, his mother and his issue. The trustees were authorized to make income and principal distributions in accordance with the instructions of the distribution committee or other grantor, acting in a non-fiduciary capacity. The distribution committee was authorized to direct distributions to qualified trusts. The IRS held that the assets of the trust will be included in the grantor's estate. Distributions of property to the grantor and directed by the committee will not be completed gifts. Distributions to non-grantor beneficiaries will be completed gifts made by the grantor.

17. Letter Rulings 201718005 and 201718006 (Issued December 20, 2016; Released May 5, 2017)

Two new rulings on incomplete non-grantor trusts

These are two of the latest letter rulings on incomplete non-grantor trusts and contain the same rulings as in prior letter rulings on incomplete non-grantor trusts. Contributions of property to the incomplete non-grantor trusts are not completed gifts and the property in the trusts is expected to be subject to estate tax in the grantor's estate. These trusts are irrevocable non-grantor trusts for income tax purposes, and these trusts are established in a state without state income taxes by residents of a state with a high state income tax, to avoid state income tax on the sale of highly appreciated assets that transferred prior to transfer to the trusts. In each of these two letter rulings, the grantor established an irrevocable trust for the benefit of himself, his descendants, and a foundation. A corporate trustee was the sole trustee.

During the grantor's lifetime, the trustee must distribute income and principal of the trust to the grantor and the permissible beneficiaries as directed by the Distribution Committee or the grantor as described below. The permissible beneficiaries were the grantor, the grantor's descendants, and a foundation.

1. Grantor's Consent Power. The trustee, pursuant to the direction of the majority of the members of the Distribution Committee, with the written consent of grantor, shall distribute to or for the benefit of the permissible beneficiaries all or any portion of the net income and principal of the trust. The Distribution Committee initially consisted of five of the grantor's children.

2. Unanimous Member Power. The trustee, pursuant to the direction of all of the members of the Distribution Committee, shall distribute to any permissible beneficiary all or any portion of the net income or principal of the trust.

3. Grantor's Sole Power. At any time, the trustee shall distribute to any of the permissible beneficiaries, other than the grantor and the foundation, all or any portion of the principal of the trust as the grantor directs for the health, education, maintenance or support of the permissible beneficiaries. This power is exercisable by the grantor in a non-fiduciary capacity.

4. Grantor's Testamentary Power. Upon the death of the grantor, the trustee was to distribute the remaining property of the trust as the grantor appointed in his last will. This was a broad special testamentary power of appointment in favor of anyone other than the grantor's estate and the creditors of grantor and of grantor's estate.

The Service first ruled that the grantor would not be treated as the owner of any portion of the trust for fiduciary income taxes purposes, under Sections 673, 674, 676, or 677 as long as the Distribution Committee remained in existence.

The Service then noted that it could not determine at this time whether the grantor would be treated as the owner of the trust under Section 675(4). The circumstances surrounding the administration of the trust would determine whether the grantor held any power of administration of a fiduciary capacity. This was a question of fact that had to be deferred until the federal income tax returns of the parties involved were examined.

The Service next concluded that the contribution of property to the trust by the grantor was not a completed gift subject to federal gift tax. In addition, any distribution from the trust to the grantor was a return of the grantor's property. Finally, upon the death of the grantor, the fair market value of the property in the trust was subject to federal estate tax.

The Service next held that a distribution of property from the trust by the Distribution Committee to any beneficiary of the trust, other than the grantor, would not be a completed gift subject to federal gift tax by any member of the Distribution Committee. Any distribution of property from the trust to a beneficiary, other than the grantor, would be a completed gift by the grantor. The powers held by the Distribution Committee were not general powers of appointment and would have no adverse estate tax consequences to member of the Distribution Committee upon their respective deaths.

18. Letter Ruling 201652002 (Issued September 15, 2016; Released December 23, 2016)

Service permits reformation of grantor retained annuity trust to correct Scrivener's error

Grantor retained an attorney to draft several grantor retained annuity trusts (GRATs) over a two year period that began after September 20, 1999. The first page of each grantor retained annuity trust provided that the grantor intended to create a grantor retained annuity trust with a retained annuity that met the requirements of a qualified interest under Section 2702(b)(1). In addition, a later provision of the trust also gave the trustees the power to amend the trust in any manner to ensure that the trust would qualify under Section 2702(b)(1). In drafting each of the grantor retained annuity trusts, the draftsperson failed to include language prohibiting the trustees from issuing a note, other debt instrument, option, or other financial arrangement in satisfaction of an annuity obligation as required by Treas. Reg. § 25.27023(d)(6).

Grantor was made aware of this failure when the grantor's son retained a new attorney to review the grantor's estate plan. As a result of that review, the trustees filed an action in court seeking reformation of each of the GRATs to correct the scrivener's error. The court issued an order reforming each trust to include the language required by the Treasury Regulations. Grantor requested a ruling from the Service that as a result of the judicial reformation of the GRATs to correct the scrivener's error, Grantor's retained annuity interest in each GRAT was a qualified interest effective as of the date that each grantor retained annuity trust was established. The IRS in reviewing the facts and noting that each GRAT provided that the grantor's retained interest was intended to be a qualified interest under Section 2702, and the fact that the trust instrument and state law permitted the amendment of each trust, ruled that, as a result of judicial reformation of each GRAT to correct the scrivener's error, the grantor's interest in each trust would be a qualified interest as of the date on which each grantor retained annuity trust was created.

19. Letter Ruling 201721006 (Issued February 13, 2017; Released May 26, 2017)

Service rules on impact of renunciation of surviving spouse's interest in QTIP marital deduction trust

The first spouse and the surviving spouse created a joint revocable trust. Upon the first spouse's death, the trust was divided into a Marital Trust, a Decedent's Trust, and a Survivor's Trust. The Marital Trust qualified for the estate tax marital deduction as a QTIP marital deduction trust.

The trustee of the Marital Trust proposed to divide the Marital Trust into separate shares, Marital Trust One and Marital Trust Two. Each share was to be administered as a separate trust for the benefit of the surviving spouse upon the same terms as the Marital Trust. The surviving spouse then planned to renounce any right, title or interest that the surviving spouse had in Marital Trust One with the result that his interest in the income and principal of Marital Trust One would terminate. At that point, Marital Trust One would be divided into separate trusts and distributed to the beneficiaries.

The following rulings were requested.

1. When the surviving spouse renounces his interest in Marital Trust One, the surviving spouse will not be deemed to have made a gift of the property in Marital Trust Two under Section 2519.

2. When the surviving spouse renounces his interest in Marital Trust One, the value of surviving spouse's income interest in Marital Trust One would not be valued at zero under Section 2702.

3. After the surviving spouse renounces his interest in Marital Trust One, no part of Marital Trust One being transferred under Section 2519 would be included in the surviving spouse's gross estate under Section 2044.

The Service first ruled that when the surviving spouse renounces his right to all title and interest in Marital Trust One, the surviving spouse will not be deemed to have made a gift of property in Marital Trust Two under Section 2519. It noted that when the surviving spouse renounces his interest in Marital Trust One, the renunciation will be deemed to be a gift of the surviving spouse's income interest in Marital Trust One under Section 2511 and a gift of all property owned by Marital Trust One other than surviving spouse's qualifying income interest in Marital Trust One, under Section 2519. The surviving spouse's gift tax liability for the transfer of the income interest in Marital Trust One will be determined under Section 2511.

With respect to the second ruling request, when the surviving spouse renounces his rights, title and interest in Marital Trust One, his interest in Marital Trust Two would not be treated as a retained interest under Section 2702. Consequently, the renunciation of the entire interest in Marital Trust One would not result in the surviving spouse's interest in Marital Trust Two being valued at zero under Section 2702.

With respect to the third ruling request, when the surviving spouse renounces the interest in Marital Trust One, the surviving spouse will be deemed to have made a transfer of all the property of Marital Trust One other than his qualifying income interest. Section 2044(b) provides that 2044(a) does not apply to any property if Section 2519 applies to the disposition of part or all of that property prior to a surviving spouse's death. Consequently, the property owned by Marital Trust One that is deemed transferred pursuant to Section 2519 will not be included in the surviving spouse's gross estate under Section 2044 at the surviving spouse's death because of the application of Section 2044(b).

20. Field Attorney Advice 20172801F (Issued May 10, 2017; Released July 14, 2017)

Advice given on whether the period of limitations on assessing gift tax remains open

Under Section 6501(a) of the Code, the period of time for assessing tax generally is three years after the gift tax return is filed. Obviously, if no return is filed for a particular year, or if a gift is not reported on a return, the statute of limitations does not begin to run, and the IRS is not foreclosed from auditing the taxpayer and assessing tax on the gifts at any date in the future. In

this Chief Counsel Memorandum, the IRS confirmed this rule with respect to a donor who had made gifts in each of six years but had not filed gift tax returns for those years.

The IRS field agent also asked about a gift made by the donor in a seventh year, which gift was disclosed on a gift tax return. This is the more fact-specific and interesting question for those who work professionally in this area. The disclosure rules go beyond whether a gift is just listed on the return. The disclosure must be adequate under the regulations.

Section 301.6501(c)-1(f) of the regulations sets forth a lengthy set of requirements for what constitutes adequate disclosure, sufficient to start the statute of limitations. Under Treas. Reg. § 301.6501(c)-1(f)(2), adequate disclosure is defined as a disclosure that adequately apprises the IRS "of the nature of the gift and the basis for the value so reported." The disclosure must include:

1. A description of the transferred property and any consideration received for it;

2. The identity of the transferor and transferee and how they were related;

3. If the transferee is a trust, the trust's tax identification number and a brief description of the trust terms (or instead of a description, a copy of the trust instrument);

4. A detailed description of the method used to determine the fair market value of the property; and

5. A statement describing any position that is contrary to IRS regulations or Revenue Rulings.

The key requirement for gifts of closely-held interests for which there is not a readily determinable market value is the description of how fair market value was determined. Section 301.6501(c)-1(f)(2)(iv) states that the return must include a detailed description of the method used to determine the fair market value, including financial data used in making the determination. For example, if the value of an interest in a closely-held corporation or partnership was derived by using the entity's financial statements and projections, those statements and projections should be attached or summarized.

Unfortunately, this particular memorandum does not provide details on what the donor did disclose on the gift tax return. It only says that the donor "did not describe the transferred property, nor did

Donor provide a description of the method used to determine the value of the transferred property." From past cases and rulings, an example of inadequate disclosure would be a listing of a gift of "a 10% limited partnership interest in the Smith Family Limited Partnership … $100,000." The disclosure does not state how the value is determined, what the underlying assets of the partnership are if the value was based on net asset value, or what valuation discounts were applied. The failure to include any one of those items could make the disclosure inadequate.

This counsel memorandum is a reminder that the IRS does look for opportunities to take a second look at returns. For gift tax returns, this often occurs as part of the estate tax audit of the donor's estate, and that can be many years later. For this reason, it is usually good practice to err on the side of very complete and thorough disclosure in the gift tax return.

ESTATE INCLUSION

21. Estate of Heller v. Commissioner, 147 T.C. No. 11 (2016)

Tax Court grants summary judgment motion that estate is entitled to theft loss deduction resulting from Madoff's Ponzi scheme

This case was decided on a motion for summary judgment. James Heller died on January 31, 2008. At the time of his death, he owned a 99% interest in James Heller Family LLC. His daughter and his son each held a 0.5% interest in the LLC. The LLC was managed by Harry H. Falk. The only asset of the LLC was an account with Bernard L. Madoff Investment Securities. The daughter, the son, and Falk were co-executors of the estate. Between March 4 and November 28, 2008, Falk, as manager of the LLC, withdrew $11,500,000 from the LLC account and distributed the withdrawal to the members according to the respective ownership interests. The estate's share of $11,385,000 was used to pay taxes and administrative expenses.

On December 11, 2008, Bernard Madoff was arrested and subsequently pled guilty to a multi-million dollar Ponzi scheme. As a result of the Ponzi scheme, the LLC's interest in the Madoff account and the estate's interest in the LLC became worthless. On the federal estate tax return, the estate reported a $26,296,807 gross estate including the value of Heller's 99% interest in the LLC at $16,560,990. The estate also claimed a $5,175,990 theft loss deduction relating to the Madoff Ponzi scheme. This amount reflected the difference between the value of the estate's interest in the LLC reported on the estate tax return and the estate's share of the amounts withdrawn from the LLC's Madoff account and distributed to the members. The government argued that the estate was not entitled to the theft loss deduction because the estate did not incur a theft loss during its settlement.

In granting the motion for summary judgment the Tax Court stated that an estate is entitled to deductions relating to "losses incurred during the settlement of *** [the estate] arising*** from theft." Under Section 2054, the issue of whether an estate is entitled to a Section 2054 theft loss deduction relating to property held by a limited liability company was an issue of first impression. The court noted that when the LLC lost its sole asset as a result of the Ponzi scheme, the estate during its settlement also incurred a loss because the value of its interest in the LLC decreased from $5,175,990 to zero. The government, while conceding that the LLC was defrauded by Madoff, contended that the estate is not entitled to a Section 2054 theft loss deduction because the LLC incurred the loss and was the theft victim.

The Tax Court rejected the government's position and held that Section 2054 allows for a broader nexus than did the government's narrow interpretation. It parsed the term "arise" and noted that it is generally defined as "to originate from a source." Pursuant to the phrase "arising from" in Section 2054, the estate was entitled to a deduction if there was a sufficient nexus

between the theft and the estate's loss. It found that the nexus between the theft and the value of the estate's interest in the LLC was direct and indisputable. As a result, the estate was entitled to a Section 2054 deduction and the court granted the estate's motion for summary judgment.

22. Letter Ruling 201707008 (Issued October 31, 2016; Released February 17, 2017)

Trust created pursuant to divorce settlement agreement to hold stock of company will not have adverse income and estate tax consequences for wife

Husband and Wife negotiated a proposed settlement agreement regarding marital support obligations and property rights. The proposed settlement agreement provided for the establishment of a trust for the benefit of Wife which would initially be funded with half of Husband's shares in Company. Wife was to receive all of the net income of the trust annually. The trustee has the discretion to make distributions of principal to Wife but was prohibited from distributing Company shares to her or from selling Company shares in order to make such principal distributions. When the trust held assets other than stock in the Company, Wife would have the right to withdraw the greater of (a) dollar amount, or (b) percent of the principal of the trust for each year. Wife did not have any powers to appoint trust property either during her life or upon her death. In exchange, Wife would relinquish all marital rights and property claims that she might have acquired while married to Husband. Upon Wife's death, the remaining trust principal would revert to Husband or Husband's estate if Husband predeceased wife.

Three rulings were requested from the IRS:

1. Wife would not recognize any income tax gain or loss upon creation of the trust pursuant to Section 1041.

2. Sections 2501 and 2702(c) would not apply or cause Wife to be treated as having made a gift of an interest in the trust to any person or persons and will not be deemed a transfer for purposes of the gift tax.

3. Except to the extent of any unexercised withdrawal right held by Wife at her death, none of the assets of the trust would be included in Wife's estate for federal estate tax purposes under any of Sections 2036, 2038, 2039 or 2041.

With respect to the first ruling request, Section 1041(a) provides that no gain or loss shall be recognized on a transfer of property from an individual to or in trust for the benefit of a spouse or former spouse incident to a divorce. Here, Husband proposed to transfer shares in the Company to the trust within six years after the entry of the final judgment of divorce. Based on the facts submitted, the IRS provided that if the transfer of the shares of stock in the Company occurred within six months after the entry of the final judgment of divorce, Wife would not recognize gain on loss on a transfer of the Company shares to the trust. On the second ruling request, the IRS found that the transfer of the shares of stock in the Company in exchange for Wife's relinquishment of her marital support property rights would constitute a transfer for full and

adequate consideration under Section 2516. Consequently, there would be no adverse gift tax consequences to Wife under either Section 2501 or Section 2702(c).

With respect to the third ruling request, the IRS noted that Husband was the transferor to the trust and not Wife. Consequently, Sections 2036 and 2038 would not apply. In addition, Section 2041 would not apply since upon Wife's death, her interest in the trust would terminate and Wife had no powers of appointment. The only amounts that might be included in Wife's estate would be amounts that pursuant to the powers of withdrawal given to her could be withdrawn or actually were withdrawn by Wife in the year of her death.

23. Estate of Sommers v. Commissioner, 149 T.C. No. 8 (2017)

Tax Court denies estate tax deduction for gift tax owed at death by decedent on gifts to decedent's nieces

In an earlier case, Estate of Sommers v. Commissioner, T.C. Memo 2013-8, the Tax Court held that a decedent, who then lived in Indiana, made valid gifts of interests in a limited liability company holding artwork to his three nieces in December 2001 and January 2002. Decedent subsequently moved to New Jersey and died in November 2002. Decedent's wife succeeded to the property she owned jointly with decedent and decedent's will gave all of his estate remaining after the payment of debts and expenses to his wife. The wife subsequently died and her beneficiaries became the ultimate beneficiaries of the estate's assets. In accordance with the agreements governing their gifts from decedent, the three nieces paid the gift tax due on those gifts. The estate filed three motions for partial summary judgement seeking determinations that:

(1) The gift tax owed at decedent's death on his gifts to nieces was deductible under Section 2053;

(2) The estate was entitled to a Section 2056 marital deduction equal to the value of decedent's non probate property that the wife received or to which she succeeded that, under applicable New Jersey law, was exempt from decedent's debts and the expenses of the estate; and

(3) Any federal estate tax due must be apportioned to the nieces and thus did not reduce the estate's marital deduction.

The three nieces filed their own motion for partial summary judgment that none of the estate tax liability could be apportioned to them.

In 2001, decedent, who was then divorced from his wife, sought legal advice on how to transfer works from his art collection to the three nieces who were then his closest living relatives. His attorneys offered two proposals to reduce or eliminate gift tax on the gift of the artwork. First the attorneys recommended that decedent transfer the artwork to a newly formed limited liability company and then make gifts of the units representing ownership interests in the entity to the nieces. This recommendation assumed that, as a result of applicable valuation discounts, the

appraised value of the units in the limited liability company would be less than the value of the artwork they represented. The attorneys also recommended that the decedent make the intended gifts in two stages, transferring some units to each niece on or before December 31, 2001 and the rest thereafter. Spreading the gifts across two years would increase the portions of the gifts that could be covered by the gift tax annual exclusion. It would also allow the decedent to use the increased applicable exclusion amount of $1 million that was scheduled to take effect in 2002. Decedent wanted to transfer the maximum number of units possible to the nieces without incurring gift tax in 2001 and then complete the gifts of the units in 2002.

In accordance with the plan, decedent transferred the artwork to the LLC and executed two sets of gift and acceptance agreements with his nieces. The first agreement was dated December 27, 2001 and the second was dated January 4, 2002. When decedent and his nieces initially executed the agreements, blanks were left for the number of units for each transfer pending completion of an appraisal of the artwork. The appraisal, when completed in March 2002, assigned a value to the artwork that led decedent's attorneys to conclude that dividing the transfers of the units across the end of 2001 would not allow for the complete avoidance of gift tax. The nieces then agreed to pay any gift tax resulting from the 2002 transfers and the gift and acceptance agreements were completed by filling in the blanks for the numbered units covered by each transfer.

In addition, decedent's nieces amended each of the 2002 agreements to add a provision pursuant to which each niece "agreed to pay the gift taxes, if any, relating to the gift of the units, including without limitation, any gift taxes, penalties, and interest that may later correctly be assessed." None of the 2002 agreements referred to apportionment of any federal estate tax liability resulting from the gifts. While none of the agreements provided for the assumption by the nieces of any liability other than gift tax, none of the agreements specifically exculpated the nieces from other liabilities.

In April 2002, decedent executed his will that directed his executor (his then ex-wife) to pay all of his just debts including funeral and burial costs and expenses of his last illness and all costs and expenses of administering and settling his estate. The nieces received all of decedent's estate remaining after payment of those debts.

In June 2002 shortly before remarrying his ex-wife, decedent initiated litigation in Indiana against his nieces challenging the validity of the purported gifts and seeking return of the artwork. The litigation in Indiana and similar litigation his ex-wife initiated in New Jersey after decedent's death on November 1, 2002 ultimately upheld the validity of the gifts. On the federal estate tax return, decedent's estate took a marital deduction of $3,330,510.43 and after taking account of all deductions, the taxable estate was $507.34. On examination, the IRS increased taxable estate from $507.34 to $1,092,106.68. This increase of $1,091,599.34 reflected three adjustments that followed from the IRS's determination that decedent's transfers of units were valid gifts. First, the IRS included the gift tax determined to be due as a result of the 2002 gifts. This amount of $510,648 was included because decedent made the gifts less than three years before his death. Second, the IRS excluded from decedent's gross estate the $1,750,000 value that the estate had assigned to the artwork that decedent had transferred to LLC. Third, the IRS reduced the marital deduction by $2,330,951.34. The decrease in the marital deduction reflected

the IRS's determination that the estate tax liability of $542,593.34 resulting from the inclusion of the gift tax paid within three years of death under Section 2035(b) that would have to be paid out of marital assets.

With respect to the first issue, the court noted that long standing precedent established that a claim against an estate is deductible in computing the estate tax liability only to the extent that it exceeds any right to reimbursement to which its payment would give rise. The court noted that the key question to examine when there was a net gift as here in which the nieces had paid the gift tax owed, is whether a decedent's estate served as the ultimate source of the funds used to pay the liability that arose when the decedent parted with the value. In this case, decedent effectively provided the nieces with the wherewithal to pay tax on the taxable gifts because for each niece, a portion of the units transferred in 2002 was ultimately determined to a taxable gift. Decedent made the transfers to the nieces before he died, withdrawing from his potential estate not only the value of the taxable gifts but also the amount of the tax on the gifts. The court also noted that if decedent's estate paid the gift tax liability after decedent's death, it would have had a claim for reimbursement against the nieces to whom decedent had already provided the wherewithal for paying the tax. The court stated that inclusion of the gift tax in decedent's estate did not justify allowing deductions for gift tax in this case anymore than in a case of a gross gift for which the decedent paid the gift tax before the decedent died. As the court put it, "[o]ur acknowledgment that a net gift made within three years of the donor's death effects a removal of funds from the transfer tax base that must be redressed by the gross-up cannot be read as acquiescence in the permanent exemption from transfer tax that would result if the gross-up were offset by a deduction of the same amount under Section 2053(a)(3)."

The court also denied the estate's motion for partial summary judgment regarding the effect of the payment of debts and claims on the marital deduction because the amount of the allowable deduction turned on the factual question of the extent to which assets otherwise exempt from claims against the estate were used to pay estate debts and expenses. Section 2056(a) allows a deduction for the "value of any interest in property which passes or has passed from the decedent to the surviving spouse". Treas. Reg. § 20.2056(b)-(4)(a) provides that value for that purpose means net value. Consequently, when property that would otherwise have been distributed to surviving spouse is used to satisfy debts of the estate, it is not included in the allowable marital deduction. The factual question of the extent to which assets otherwise exempt were used to pay debts and expenses precluded summary judgment since this was an issue of material fact and summary judgment may only be granted when there is no issue of genuine material fact.

The court then found that under the New Jersey's estate tax apportionment statute, no portion of any estate tax could be apportioned to the three nieces. Because the LLC units the three nieces received from their uncle were not included in computing the decedent's federal estate tax liability under the New Jersey apportionment statute, the nieces were not "transferees" against whom any of the estate tax liability could be apportioned for purposes of the New Jersey apportionment statute.

The court next looked at whether the payment of the estate tax would reduce the marital deduction claimed by the estate and held that the existing record did not allow for the determination of the effect of the payment of the estate tax on the allowable marital deduction. To the extent that the executor used the property that otherwise would have been exempt from

claims against the estate to pay debts or expenses, the estate may have been a "transferee" subject to the apportionment of estate tax under the New Jersey apportionment rules. If neither the estate nor the nieces were "transferees" subject to the apportionment statute, the federal estate tax liability would be apportioned entirely to the estate. To the extent that any tax apportioned to the estate reduced the residuary distributions ultimately made to the wife's beneficiaries, the tax would be paid out of that marital share of the estate. The court did note that the New Jersey statute requires that total estate tax be apportioned in a manner that reserves for the benefit of decedent's spouse, to the extent possible, the benefit of any marital deduction. That statute provided insufficient grounds to rule that as a matter of law any estate tax due could not affect the allowable marital deduction.

24. Letter Rulings 201737001 and 201737008 (Issued June 14, 2017; Released September 15, 2017)

Reformation of power of appointment to make it a limited power of appointment is recognized

Grantor created an irrevocable trust to benefit spouse and descendants. The irrevocable trust contained a special power of appointment that provided that on the death of the spouse, the trustee is to distribute such amounts of principal and income as the spouse directed to such persons or charities as the spouse appointed by her will. The terms of the power of appointment did not specifically limit the exercise of the power to appoint to persons other than the spouse, the estate of the spouse, and the creditors of either. It was represented that the grantor intended for the power of appointment to be a limited power of appointment and not a taxable general power of appointment.

The grantor filed a petition with the local court to reform the trust to provide that the spouse would have a limited power of appointment and for the retroactive application of the reformation. The IRS ruled that because of the representations that the grantor did not intend for the spouse to have a general power of appointment and the representation of the lawyer who drafted the trust that an error had been made, the power of appointment as reformed by the local court would not constitute a general power of appointment and that the reformation of the trust was not the exercise or release of a general power of appointment that would constitute a gift by the spouse for federal gift tax purposes.

VALUATION

25. Proposed Regulations under Section 2704, 81 Fed. Reg. 51413 (August 4, 2016)

Proposed Section 2704 Regulations would impose major restrictions on valuation discount planning

Long-awaited proposed regulations under Section 2704 of the Internal Revenue Code, released on August 2, 2016, would make sweeping and very significant changes to the valuation of

interests in many family-controlled entities for estate, gift, and generation-skipping transfer tax purposes. The primary focuses of the proposed regulations are treating the lapse of voting or liquidation rights as an additional transfer and disregarding certain restrictions on liquidation in determining the fair market value of a transferred interest.

Background. In 1990, Congress enacted Section 2704 of the Internal Revenue Code, entitled "Treatment of Certain Lapsing Rights and Restrictions," in an effort to limit the valuation discounts for gift and estate tax purposes applicable in the case of intra-family transfers of interests in family-owned, or "closely-held," corporations and partnerships. If an individual and the individual's family hold voting or liquidation control over a corporation or partnership, Section 2704(a) provides, in general, that the lapse of a voting or liquidation right shall be taxed as a transfer subject to gift or estate tax. Section 2704(b) provides, in general, that when an interest in a family-owned corporation or partnership is transferred within the family, if a restriction limits the ability of the corporation or partnership to liquidate and that restriction can be removed by the family, that restriction is disregarded in valuing the transferred interest for gift or estate tax purposes.

Finally, in Section 2704(b)(4), Congress authorized Treasury to issue regulations providing "that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

Tax professionals have been expecting these regulations for many years. Treasury and the Internal Revenue Service have included these regulations as a project in their Priority Guidance Plan every year since 2003. From 2009 until 2012, the regulatory project was supplemented in the Administration's annual budget proposals by a recommendation that Congress clarify or enlarge Treasury's regulatory authority to disregard other restrictions, referred to as "disregarded restrictions," to be measured by standards provided in regulations. This request for legislative action was dropped in 2013 after it failed to gather support. Meanwhile, the Section 2704(b) regulatory project continued to appear in every annual Treasury-IRS Priority Guidance Plan.

The Proposed Regulations. The IRS released the Section 2704 proposed regulations on August 2, 2016, and they were published in the Federal Register on August 4. 81 Fed. Reg. 51413-51425 (Aug. 4, 2016). If and when finalized, the proposed regulations would:

- Treat as an additional transfer the lapse of voting and liquidation rights for transfers made within three years of death of interests in a family-controlled entity, thereby eliminating or substantially limiting the lack of control and minority discounts for these transfers;

- Eliminate any discount based on the transferee's status as a mere assignee and not a full owner and participant in the entity;

- Disregard the ability of most nonfamily member owners to block the removal of covered restrictions unless the nonfamily member has held the interest for more than three years, owns a substantial interest in the entity, and has the right, upon

six months' notice, to be redeemed or bought out for cash or property, not including a promissory note issued by the entity, its owners, or anyone related to the entity or its owners;

- Disregard restrictions on liquidation that are not mandated by federal or state law in determining the fair market value of the transferred interest; and

- Clarify the description of entities covered to include limited liability companies and other entities and business arrangements, as well as corporations and partnerships.

If the final regulations are similar to the proposed regulations, taxpayers will have lost a significant estate planning technique, and the tax cost of transferring interests in family-owned entities will increase.

Lapse of Voting or Liquidation Rights. Treasury and the IRS have been concerned that taxpayers are able to structure transfers of interests in a family-owned entity so that the transferees would not individually have the power to liquidate or control the entity but the transferees together would be able to control or liquidate the entity. Thus, the transferor's right to control or liquidate the entity would not pass to any of the transferees individually and would not be subject to transfer taxes. Because the transferees do not have voting control or the right to liquidate the entity, the values of the transfers for transfer tax purposes are reduced by lack of control or minority interest discounts that could range from 30 to 50 percent or even higher.

Section 2704(a) treats the lapse of a voting or liquidation right in a family-owned entity as a transfer by the individual holding the right immediately before its lapse. The current regulations exempt such a transfer if the rights with respect to the transferred interest are not restricted or eliminated. The proposed regulations would deny that exemption for transfers occurring within three years before the transferor's death if the entity is controlled by the transferor and members of the transferor's family immediately before and after the lapse. Although the informal legislative history of Section 2704 states that the enactment of Section 2704 in 1990 was not intended to eliminate minority or lack of control discounts, the proposed regulations apparently would now have that effect in some cases.

The proposed regulations modify an example in the regulations to illustrate the impact of this provision. An individual owning 84 percent of the stock in a corporation whose bylaws require at least 70 percent of the vote to liquidate gives one-half of the individual's stock in equal shares to the individual's three children. The individual in this example gave up the individual's right to liquidate or control the corporation by making the gift. The example provides that if these transfers had occurred within three years of the individual's death, the transfers would have been treated as if the lapse of the liquidation right occurred at the individual's death. The result is tantamount to including in the transferor's gross estate an additional "phantom asset" that will not qualify for the estate tax marital or charitable deduction.

Disregarding Certain Restrictions on Redemption or Liquidation. The proposed regulations would also make significant changes to the valuation for transfer tax purposes of interests in a family-controlled entity that are subject to restrictions on redemption or liquidation—that is,

subject to limitations on the ability of the owner of the interest to require the entity or other owners to redeem or buy out that owner. The overall effect of Section 2704(b) is that specified restrictions are disregarded in valuing such an interest for gift or estate tax purposes when that interest is transferred to a family member. Under the proposed regulations, the threshold element of the new type of disregarded restriction is still the fact that after the transfer the restriction will lapse or can be removed by the transferor or any member or members of the transferor's family. For this purpose, interests held by nonfamily members, which otherwise might give those nonfamily members the power to prevent the removal of a restriction, are disregarded unless those interests have been held for at least three years, represent at least 10 percent of the entity (and 20 percent in the aggregate with other nonfamily members), and can be redeemed by the nonfamily holder on no more than six months' notice.

But rather than describing the kinds of such lapsing or removable restrictions that will be disregarded in making such valuations, the proposed regulations define those restrictions with reference to the effect they would have on gift or estate tax value. If the effect of a restriction on an interest in an entity is to limit the ability of the holder of that interest to compel liquidation or redemption of that interest on no more than six months' notice for cash or property equal at least to what the proposed regulations call "minimum value," then the restriction is disregarded. "Minimum value" is defined as the pro rata share of the net fair market value of the assets of the entity—that is, the fair market value of those assets reduced by the debts of the entity, multiplied by the share of the entity represented by that interest. Because the valuation of interests when those restrictions are disregarded is still a complex matter, these rules do not mean that all interests in entities will necessarily be valued on a "look-through" basis at their pro rata share of the net value of the assets of the entity, but the proposed regulations would certainly move much closer to such a model.

The property for which the interest may be redeemed at the holder's election cannot include a promissory note or other obligation of the entity, its owners, or persons related to the entity or its owners, except for a note issued by an entity engaged in an active trade or business that, as the proposed regulations state, "is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds." It is very significant that the proposed regulations specify "market interest rates" and "fair market value," rather than an "applicable federal rate" or other objective rate determined from published sources and a value inferred from the use of such a rate. This small difference in wording is likely to produce a huge difference in the ease of administration of these new rules.

Restrictions Imposed or Required by Law. Section 2704 exempts restrictions on the owners' ability to liquidate the entity "imposed or required to be imposed, by any Federal or State law." The current regulations state that "[a]n applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction" (often referred to as the "default" state law). When Section 2704 was enacted and the current regulations were issued, the state law applicable to partnerships granted owners certain rights to liquidate the entity. Since then, state legislatures have tightened their default laws, appearing to support provisions in partnership agreements that more significantly restrict the liquidation rights of the owners. Tax advisors have taken advantage of those state laws to increase the restrictions

in partnership agreements so as to decrease the transfer tax value of partnership interests. Because those restrictions were consistent with the default state law, the restrictions were not applicable restrictions and were respected for transfer tax purposes.

The proposed regulations would provide, in effect, that a default state law restriction that may be superseded by the governing documents is not a restriction imposed or required to be imposed by Federal or state law. Because most states allow the governing documents of an entity to override any restrictions on transfer, there will be few if any applicable restrictions that will reduce the value of an interest in a family-controlled entity for transfer tax purposes if the proposed regulations become final.

Covered Entities. Although Section 2704, when it was enacted, referred only to corporations and partnerships, the proposed regulations would clarify that they also apply to limited liability companies and other entities and business arrangements, as well as corporations and partnerships.

Effective Dates. The provisions of the proposed regulations applicable to voting and liquidation rights are proposed to apply to rights and restrictions created after October 8, 1990, but only to transfers occurring after the date the regulations are published as final regulations. The new rules described above under the heading "Disregarding Certain Restrictions on Redemption or Liquidation" will not take effect until 30 days after the date the regulations are published as final regulations.

There will be significant comments to the proposed regulations and lively discussion at the public hearing scheduled for December 1, 2016. The earliest the regulations will likely become final will be sometime in 2017.

Immediate Planning. Clients who are considering transferring interests in family-controlled entities that are not controlling interests and do not have liquidation rights should consider making the transfers as soon as possible. It is possible, however, that if the client dies within three years of the transfer and after the date that the proposed regulations become final, the client may be caught by the final regulations. The proposed regulations would also apply to determine and measure any gift component of transfers otherwise structured as sales. Likewise, clients who have recently made transfers and die after the regulations are finalized but within three years of the transfer may be caught by the final regulations.

Long-Term Planning. Because of the broad sweep of the proposed regulations, there will be challenges to Treasury's authority to adopt them in their present form. Meanwhile, attention should be given to the provisions in existing and future operating agreements and other governing documents and also to the source for payment of the tax on any potential "phantom asset."

26. Notice 2017-38, 2017-30 I.R.B. 147 (July 7, 2017)

IRS identifies eight regulations that meet requirements of April 21, 2017 Executive Order for the Treasury Department to recommend specific actions to mitigate the burdens identified with respect to those regulations

The Department of Treasury issued its proposed regulations under Section 2704 of the Code on August 2, 2106. As discussed previously, the proposed regulations appeared to make significant, fundamental changes to the rules for valuing interests in family held corporations, partnerships and LLCs. As written, the regulations appeared to impose a new valuation regime where the value of any owner's interest in a corporation, partnership or LLC (even a 1% interest) must be determined as if there was no state law or governing document restriction on the ability of the owner to immediately redeem the interest or force liquidation of the entity, and be paid within 6 months.

The reaction to the proposed regulations from the attorneys and other wealth management professionals was swift and loud. Treasury received over 11,300 written comments, and presentations at the hearing held on the regulations almost all were negative. Several members of Congress suggested legislation to prevent Treasury from issuing the regulations. Treasury and IRS officials responded by stating have commented that practitioners were over-reacting and that the proposed regulations were not meant to eliminate minority discounts or significantly alter valuations for transfer tax purposes. Rather, they said that the regulations were intended to address provisions that purport to artificially make the interest less marketable and *artificially* enhance the discounts justified by real factors. Treasury representatives acknowledged that they would need to rework the regulations to address this misunderstanding.

The newly elected Trump administration also expressed opposition to regulatory burdens in general. On April 21, 2017, President Trump signed Executive Order 13789, which directed the Treasury Department to review all "significant tax regulations" issued on or after January 1, 2016 and identify those regulations that (i) impose an undue financial burden on U.S. taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the IRS. The Department of Treasury issued its initial report in Notice 2017-38, which was released on July 7. The Notice identified eight regulations that met at least of the first two criteria in President Trump's executive order. The Section 2704 proposed regulations were on the list.

The Department of Treasury is supposed to issue a second report by September 18, 2017, recommending specific actions to mitigate the burden of the regulations. Those mitigating actions must be completed, on an interim report published within another 180 days (by March 17, 2018) and the Treasury Department, the Office of Management and Budget must review and if necessary change the procedures to insure the future tax regulations avoid the undue burdens.

Most practitioners view the inclusion of the Section 2704 proposed regulations on the list as further confirmation that they are, at a minimum, on indefinite hold; and that they may be destined for the chopping block. After all, the easiest way for Treasury to "mitigate the burden" of the regulations is to withdraw them.

Interestingly, the May 30, 2017 Bloomberg BNA Daily Tax Report reported, "in the domestic arena, the American Institute of CPAs is pushing Treasury to drop widely disliked rules to stem estate tax valuation abuses, and pressure in that area is only going to ramp up. Jonathan Horn of AICPA is a senior manager for tax policy and advocacy, told Bloomberg BNA that this will be his group's highest priority. "

The American College of Trusts and Estates Council recommended in comments to the notice that the following steps should be taken:

1. The confusion about a "put right" and minimum value as a new standard of value should be cleared up.

2. Almost all interests of non-family members should not be ignored under the regulations.

3. Family owned operating businesses should be explicitly exempted.

4. Family members who never had control of a family owned business should be exempted

5. The proposed three-year rule for taxing lapses as transfers should be changed to something like the rules under Section 7520.

6. All the final rules, not just the disregarded restriction rules, should be made effective thirty days after publication.

Finally, ACTEC commented that the proposed regulation should be withdrawn and should only be re-proposed if and when the changes recommended by ACTEC are implemented.

27. Estate of Beyer v. Commissioner, T.C. Memo 2016-183

Tax Court denies discounts for limited partnership interests included in decedent's estate

Edward G. Beyer never married and had no children. He did have four sisters, two nephews and a niece. Beyer primarily worked for Abbott Laboratories and became the company's chief financial officer. Beyer acquired stock options and exercised those options beginning in 1962. By 1999, Beyer held 800,000 shares of Abbott stock, and other stock, certain non-cash property, and a certain amount of cash. Beyer established a revocable trust in 1999 to which he transferred the Abbott stock and a brokerage account.

In 1999, Beyer engaged in other estate planning. In 2001, Beyer gave his nephew, Craig Plassmeyer, a power of attorney over his property. In 2003, Beyer established a limited partnership and his stock in Abbott Laboratories and other marketable securities and mutual funds were transferred to the partnership. Beyer was apparently the only limited partner and general partner in the partnership. He retained a checking account and a money market account

in his name. Beyer subsequently established an irrevocable defective grantor trust and funded it with ten dollars. While the irrevocable trust still had only ten dollars in assets, it purchased $20,866,724 worth of limited partnership interests. This represented the 99% limited partnership interest. Beyer died in 2007. Upon Beyer's death, the estate filed an estate tax return showing an estate tax of $9,345,334. The check to pay the estate tax was drawn on the bank account for the limited partnership. On Beyer's estate tax return, the value of the promissory note and his one percent general partnership interest in the limited partnership were listed. The court noted that Beyer held both the general partnership interest and the limited partnership interest and questioned whether the limited partnership was a true limited partnership. However, it proceeded on that assumption.

The court then applied the test for a valid transfer of property to avoid the application of Section 2036(a) under Estate of Bongard v. Commissioner, 124 T.C. 95 (2005). The court first held that the bona fide sale exception was not satisfied because the estate could not show that there was a valid non-tax reason for the partnership. The court first rejected the argument that Beyer used the partnership to keep the Abbott stock in a block and to maintain his investment portfolio intact. It noted that Beyer could have accomplished this through amendment of the terms of his revocable trust as they would apply after his death to the interests received by his beneficiaries. It next rejected the estate's argument that the limited partnership was necessary so that Craig Plassmeyer could be transitioned to managing the assets. The court stated the Craig Plassmeyer could have held such powers either as an agent under a power of attorney or as a trustee or co-trustee of Beyer's revocable trust. The court finally rejected the estate's contention that the partnership was needed for the continuity of the management of the assets. The court stated that the trust could have been amended to name Craig Plassmeyer (or any other individual or company) to act as trustee or co-trustee to manage the assets regardless of whether he created the partnership.

The court also found that Beyer failed to receive full and adequate consideration in money or money's worth for the property transferred to the partnership. The partnership failed to establish and maintain respective capital accounts for its partners including any general partner and any limited partner and to show the interests of each partner either upon the initial contributions to the partnership or upon subsequent contributions to the partnership. As a result, the estate failed to carry its burden of providing credible evidence that Beyer received adequate and full consideration in money or money's worth.

The court then found that the estate failed to meet its burden of showing that there was no implied agreement or understanding that Beyer, after his April 2014 transfer of property to the partnership, retained the possession or enjoyment of the property. Beyer continued to use the assets he transferred to the partnership and he failed to retain sufficient assets outside the partnership to meet anticipated financial obligations. The court noted that one payment by the irrevocable trust to Beyer's revocable trust far exceeded the amount of interest required each quarter on the promissory note. The court also noted that Mr. Beyer knew at the time that he established the partnership that payments would be necessary from the partnership to pay estate tax when he died. The court then denied any discount for the inclusion of the limited partnership assets in Beyer's estate.

28. Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017)

Tax Court includes entire value of underlying assets of family limited partnership in estate of decedent

Powell is the latest case exploring the viability of claimed valuation discounts for interests held by the decedent in a family limited partnership or limited liability company. It is a decision of the full Tax Court, sitting en banc. That gives the decision more weight, which is somewhat unfortunate because this is an example of bad facts make unfavorable law. Procedurally, Judge Halpren's opinion was agreed to by seven other tax court judges. Two Tax Court judges concurred in the result only. Judge Lauber wrote an opinion concurring in the result only in which he disagreed with the theory on which the underlying value of the assets in the partnership were included in the decedent's estate. Judge Lauber's concurring opinion was joined by five Tax Court judges.

The first part of the decision focused on the IRS' use of Section 2036 to assert that no valuation discounts are appropriate because the underlying assets transferred to the LP or LLC should be brought back into the estate. Section 2036 will apply if:

1. Decedent made an inter vivos transfer of property;
2. Decedent retained the income from or the use and enjoyment of the property until his or her death; and
3. The transfer of property was not a bona fide transfer for full and adequate consideration.

The most cited case for the Service's Section 2036 argument is Estate of Bongard v. Commissioner, 124 T.C. 95 (2005). The Bongard case explains that there can be an implied agreement to retain the income from the transferred assets where the transfer to the partnership arguably leaves the decedent without adequate separate funds to support their lifestyle. In addition, the transfer will not be considered to be bona fide and for full and adequate consideration if there are not a legitimate and significant nontax reasons for forming the partnership.

The executor in Powell stood little chance of establishing significant nontax reasons for the partnership because its formation was very much a last minute transaction. Jeffrey Powell, the son of Nancy Powell, created NHP Enterprises LP as Nancy's agent under a power of attorney a mere week before Nancy Powell died. He transferred $10 million of Nancy's assets, to the partnership for a 99 percent limited partnership interest. Her two sons contributed property for the one percent general partnership interest. The partnership had all the earmarks of a deathbed planning device with no purpose other than to reduce taxes. The Tax Court agreed with the IRS that there was an implied agreement to retain control of the use and enjoyment of the property by others under Section 2036(a)(2) and no significant nontax purpose for creation of NHP Enterprises.

The family's argument in response was that there could not be a retained implied agreement because, on the same day as the funding of the partnership, Jeff, again acting as agent, transferred Nancy's 99% LP interest to a charitable lead annuity trust. Therefore, there was

nothing for Nancy to retain under Section 2036. This argument failed for two reasons. First, the power of attorney under which Jeff operated did not authorize gifts greater than annual exclusion gifts to anyone other than Nancy's descendants. Therefore, the transfer to the CLAT was voidable. Second, even if the transfer was not voidable, the transfer to the CLAT constituted a transfer of a retained Section 2036 interest made within 3 years of death (in this case within a week of death). Section 2035(a)(2) brings such transfers back into the estate.

This court applied Section 2036(a)(2) to bring the assets of the partnership back into the estate (which argument the family did not contest). The majority opinion stated that 2036(a)(2) applied since Nancy, in conjunction with the other partners, could dissolve the partnership and Nancy, through Jeff as general partner and as her agent under the power of attorney could control the amount of distributions from the partnership and the timing of those distributions. Judge Lauber noted that Nancy Powell clearly made a transfer of 10 million in cash and securities and she clearly retained the proverbial "string" that pulled those assets back into her estate.

The court adopted the arguments advanced in Estate of Strangi v. Commissioner, T.C. Memo 2003-15, aff'd, 417 F.3d 468, to show why the fiduciary duty limitation of United States v. Byrum, 408 U.S. 125 (1972) did not apply. Byrum held that the retention of the right to vote the shares of stock in a closely held corporation transferred to an irrevocable trust by the majority shareholder was not a retained right under Section 2036(a)(2) since any decision would be constrained by fiduciary duties to other shareholders. Here, the Tax Court went to great lengths to distinguish this case from the fiduciary duties in Byrum. These differences included the following: (i) the inability of Jeff as general partner and the agent under the power of attorney to act in ways that prejudiced Nancy's interests; (ii) Jeff owed duties almost exclusively to Nancy since Nancy owned 99 percent of the interests in the partnership; and (iii) the partnership conducted no business activities. This differs from Byrum, which involved an operating entity.

Powell follows two other recent cases in which the IRS successfully applied Section 2036, Estate of Holliday v. Commissioner, T.C. Memo. 2016-51 and Estate of Beyer v. Commissioner, T.C. No. 2016-183. The case is a prime example of why deathbed attempts to use a limited partnership or LLC to obtain valuation discounts stand a strong chance of failing.

Judge Halpren also on his own raised the question of how Section 2036 operates in conjunction with Section 2043 to avoid double taxation. Section 2043(a) states that if a transfer is subject to Sections 2035 to 2038 and 2041 which is not a bona fide sale for money or money's worth for full and adequate consideration in money or money's worth, then only the excess of the fair market value of the property on the dated of death over the valuation of the consideration received will be included in the estate. Essentially, under this approach, the value of discounted partnership interests are included in the estate under Section 2033 and the amount of the discounts is included under Sections 2036 and 2043 which Judge Halpren referred to as the doughnut hole. This only avoids double inclusion if the assets in the partnership do not appreciate between the date of transfer into the partnership and the date of death. If the assets in partnership decrease in value between the date of transfer into the partnership and the date of death, there will be a reduction in taxes owed.

Judge Lauber, in his concurring opinion, did not find any "double inclusion" problem. He noted that Nancy's supposed partnership interest had no value apart from the cash and securities that

she allegedly contributed to the partnership. The partnership was an empty box into which the $10 million was notionally placed. Once the $10 million is included in her gross estate under Section 2036(a)(2), it was perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities. Judge Lauber chastised Judge Halpren for avoiding this straight forward path to the correct result and instead adopting Section 2043(a) as the linchpin for his analysis. He noted that neither party in the case advanced any argument based on Section 2043(a) nor was that the Section was cited in either party's briefs. Judge Lauber also referred to the Judge Halpern's discussion of Section 2043(a) as a solution in search of a problem.

29. Estate of Clara M. Morrissette, 146 T.C. No. 11 (2016)

Split-dollar life insurance arrangements at issue are governed by the economic benefit regime and not the loan regime

Split-dollar is a method of financing the purchase of insurance. It most typically takes the form of an arrangement between a closely held business and an owner-employee, or between a public corporation and its executives, in which the employer and employee agree to split the payment of premiums on an insurance policy on the life of the insured. In 2001, the IRS announced its intent in Notice 2001-10, 2001-1 C.B. 459, to change its tax treatment of split-dollar arrangements. Thereafter, it issued new regulations, in final form, on September 17, 2003. The new taxation scheme created under these regulations significantly altered the way in which split-dollar arrangements were used for estate planning purposes thereafter.

Under the regulatory scheme put in place in 2003, two mutually exclusive methods for taxing split-dollar life insurance arrangements now apply, the economic benefit regime and the loan regime. If the employer is the owner of the insurance policy, the split-dollar arrangement will be taxed as compensation related agreement under the economic benefit regime. The value of the current life insurance protection and any other benefits derived by the insured employee from the arrangement will be treated as taxable income to the employee under Section 61 of the Internal Revenue Code. The economic benefit rules apply to both arrangements where the policy is actually owned by the employer (endorsement method split-dollar arrangements) and to arrangements in which the employee owns the policy (collateral assignment split-dollar arrangements) but the employee's only right is to the insurance protection. In this latter situation, the employer will be deemed to own the policy. Treas. Reg. § 1.61-2(c)(1)(ii)(A)(2).

Any split-dollar arrangement not described above in which the employee owns the policy will be governed under the loan regime by the Section 7872 below market loan rules. Here, transfers by the employer will be treated as loans and there will be deemed interest to the extent that the arrangement does not mandate adequate interest. The deemed interest will treated as compensation paid by the employer to the employee and then repaid as interest by the employee. The same rules will apply to split-dollar arrangements in all other contexts, such as shareholder-company and private donor-donee arrangements.

Morrissette involved a motion for partial summary judgment in a private donor-donee arrangement. The unique feature here is that the insureds were much younger than the donor. In Morrissette, Clara Morrisette established a revocable trust in 1994 to which she contributed all of her shares in Interstate Group Holdings which, in turn, held eleven moving and other companies. In September 2006, when Clara Morrissette was 93, her three sons became trustees of the revocable trust. Previously, on August 18, 2006, an employee of Interstate Group Holdings was appointed as a temporary conservator of Clara's Morrisette's estate through October 20, 2006. The conservator transferred additional assets into the revocable trust. In addition, the conservator established three perpetual dynasty trusts in 2006, one for each of her three sons and his family. The revocable trust was amended on September 19, 2006 to permit the trustees to pay premiums on life insurance and to make loans and to enter into split-dollar arrangements.

Next, on September 21, 2006, the dynasty trusts, the three brothers, the revocable trust, and other trusts holding interests in Interstate Group Holdings entered into a shareholders agreement providing that upon the death of each brother, the surviving brothers and the dynasty trusts would purchase the Interstate Group Holdings stock held by or for the benefit of the deceased brother. To provide each dynasty trust with the funds to purchase the Interstate Group Holdings stock held by a deceased sibling, each dynasty trust on October 4, 2006 purchased a universal life policy on the life of each of the two other brothers.

On October 31, 2006, Clara Morrissette's revocable trust entered into two split-dollar life insurance arrangements with the three dynasty trusts and then contributed $29.9 million in total to the three dynasty trusts in order to fund the purchase of the universal life insurance policies on each of Clara Morrissette's three sons. The split-dollar life insurance arrangements provided that the revocable trust would receive the greater of the cash surrender value of the respective policy or the aggregate premium payments on that policy upon termination of the split-dollar life insurance arrangement or the death of the insured brother. The right to receive a portion of the death benefit would thus be a receivable of the revocable trust.

Each split-dollar agreement provided that the agreement would be taxed under the economic benefit regime and that the only economic benefit provided to each dynasty trust was the current life insurance protection. The dynasty trusts executed collateral assignments of the policies to the revocable trust to secure the payment of the amounts owed to the revocable trust. Neither the dynasty trusts nor the revocable trust retained the right to borrow against the policies.

In each of 2006 through 2009, Clara Morrissette reported gifts to the dynasty trusts under the economic benefit regime of the cost of the current life insurance protection determined under Table 2001, less the amount of the premiums paid by the dynasty trusts. Clara Morrissette died on September 25, 2009 and was survived by her three sons. After Mrs. Morrissette's death, the estate retained Valuation Services, Inc. to value the receivables included in the gross estate as of the date of her death. Valuation Services, Inc. valued the receivables at $7,479,000.

In the audit of Clara Morrissette's estate, the IRS determined that the $29.9 million contribution was a gift in 2006 and assessed a gift tax deficiency against Clara Morrissette's estate of $13,800,179 and a penalty of $2,760,036. The estate moved for partial summary judgment on the narrow issue of whether the split-dollar insurance arrangements were governed by the economic benefit regime under Treas. Reg. § 1.61-22.

The court first noted that the 2003 final regulations governed the split-dollar arrangements since they were entered into after September 17, 2003. The court also noted that generally the person named is the owner in the insurance contract is treated as the owner of the contract. Under this general rule, the dynasty trusts would be considered the owners of the policies and the loan regime would apply. However, the final regulations included the special ownership rule that provided that, if the only economic benefit provided under the split-dollar life insurance arrangement to the donee is the current life insurance protection, then the donor will be deemed the owner of the life insurance contract, irrespective of actual policy ownership, and the economic benefit regime will apply.

To the court, the key question was whether the lump sum payment of premiums made directly made by the revocable trust on the policies in 2006 generated any additional economic benefit other than the life insurance protection to the dynasty trusts. If there was no additional economic benefit to the dynasty trusts, then the revocable trust would be deemed the owner of the policies by way of the special ownership rule and the split-dollar life insurance arrangements would be governed by the economic benefit regime. To determine whether any additional economic benefit was conferred, the relevant inquiry was whether the dynasty trusts had current access to the cash values of the respective policies under the split-dollar life insurance arrangement or whether any other economic benefit was provided. The court determined that the dynasty trusts did not have access to any part of the cash value of the insurance policies or to any other economic benefit except for the current life insurance protection. As a result, the economic benefit regime and not the loan regime applied.

The important issue yet to be determined with respect to Morrissette is the value of the receivables in Clara Morrissette's estate for estate tax purposes and whether the receivables should only be valued at approximately $7,500,000. The resolution of this issue will determine the usefulness for estate and gift tax purposes of the split-dollar financing of the policies in this particular situation.

30. Estate of Marion Levine v. Commissioner, Tax Court Docket Number 9345-15

Tax Court follows Morrissette decision

The Tax Court granted the petitioner's motion for summary judgment on the issue that the split-dollar life insurance arrangement at issue was governed by the economic benefit regime and not the loan regime, because of the Tax Court's opinion in Estate of Morrissette v. Commissioner, 146 T.C. No. 11 (2016). Levine involves the IRS's imposition of $2.9 million in back taxes and accuracy related penalty of $1.1 million in compensation with the split-dollar financing of life insurance policies in an irrevocable life insurance trust.

The taxpayer argued that Morrissette controlled in this situation and the IRS agreed. The IRS disagreed with the decision in Morrissette, and by opposing the Motion for Summary Judgment, the IRS preserved its right to appeal in Levine.

31. Letter Ruling 201633001 (Issued April 25, 2016; Released August 12, 2016)

IRS grants trustee extension of time to elect special use valuation for farm land

Decedent's estate included farm land. The personal representative retained an accountant to prepare and file the Form 706. The accountant failed to advise the personal representative about special use valuation under Section 2032A. As a result, when the Form 706 was filed timely, the personal representative failed to make the Section 2032A Special Use Valuation Election.

After filing the Form 706, the accountant discovered the failure to advise the personal representative of the need to make the Section 2032A election on the Form 706. The accountant subsequently filed a supplemental Form 706 and elected the special value for the farm land under Section 2032A. The estate requested an extension of time to make the Section 2032A election under Treas. Reg. §§ 301.9100-1 and 301.9100-3.

Treas. Reg. § 301.9100-3 provides that a request to make an extension of time will be granted when the taxpayer provides evidence to establish if the taxpayer acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

The Service found that the requirements of the regulation had been met and granted an extension of time to make the special use valuation.

32. Estate of Giustina v. Commissioner, T.C. Memo. 2016-114

Tax Court adjusts valuation of limited partnership interests for estate tax purposes

In Estate of Giustina v. Commissioner, 586 F.3d 14417 (9th Cir. 2014), reversing and remanding T.C. Memo. 2011-114, the Ninth Circuit remanded a case to the Tax Court with respect to the valuation of a 41% limited partnership interest.

In that case, the Tax Court held that the value of the limited partnership interest was $27,454,115. The Ninth Circuit held that the Tax Court's valuation was flawed because the Tax Court should not have considered the value of the assets owned by the partnership. It remanded the case for the Tax Court to recalculate the value using the partnership's value as a going concern. The Ninth Circuit also held that the Tax Court erred by failing to adequately explain its reason for reducing the partnership's specific risk premium from 3.5% to 1.75%. The estate had originally valued the interest at $12,995,000. On remand, the court determined that the value of the 41% limited partnership interest was $13,954,730.

33. Estate of Kollsman v. Commissioner, T.C. Memo 2016-40

IRS experts found to be more creditable in valuation of old masters paintings for estate tax purposes

Eva Franzen Kollsman died on August 31, 2005. The assets of the estate included two 17th century old master paintings. One was "Village Kermesse, Dance around the May Pole" by Pieter Brueghel the Younger and the second was "Orpheus Charming the Animals" by one of Jan Brueghel the Elder, Jan Brueghel the Younger or a Brueghel studio.

The estate's expert was George Wachter of Sotheby's. He first saw the two paintings in 1981 during a visit to decedent's residence and visited her on several subsequent occasions over the years.

Around the time of decedent's death, Wachter wrote to the executor outlining the terms under which Sotheby's would handle the auctioning of the two paintings. He stated that the preliminary estimates of the sale prices that the paintings would bring at Sotheby's January 2006 auction in New York were $600,000–$800,000 for May Pole and $100,000–$150,000 for Orpheus. One reason for the low value was the dirty condition of the two paintings and the possible damage that could occur from cleaning the two paintings.

On September 28, 2005, Sotheby's sent the executor two documents prepared by Wachter. The first took the form of a letter from Wachter to the executor in which he stated that the fair market values of May Pole and Orpheus, based on first hand inspection of the property (without further elaboration), were $500,000 and $100,000 respectively. This letter was subsequently attached to the estate tax return. The second document was a letter agreement for the consignment to Sotheby's of the right to auction May Pole and Orpheus for five years. The values of May Pole and Orpheus described in the consignment rights agreement were $600,000–$800,000 and $100,000–$150,000 respectively. At the time of the agreement, Sotheby's imposed a buyer's premium equal to 20% of the first $200,000 of the "hammer price" and 12% of any access amount. May Pole was sold at Sotheby's in the January 2009 Old Masters Auction for a hammer price of $2.1 million against a presale estimate of $1.5 million to $2.5 million. The total purchase price, including the buyer's premium, was $2,434,500.

The IRS, after receiving the estate tax return, determined the fair market value of May Pole as $1,750,000 and Orpheus as $300,000. Subsequently, the IRS amended its values so that May Pole was valued at $2,100,000 and Orpheus was valued at $500,000. The court rejected Wachter's valuations. It noted that he had a significant conflict of interest that could cause a person to question his objectivity. In addition, while the paintings were dirty when received and subsequently cleaned, Wachter had exaggerated the dirtiness of the paintings on the valuation date and the risks involved in cleaning them. Two witnesses from a leading conservator had indicated the cleaning to be a well advised and low risk undertaking. Also, Wachter provided no comparables to support his valuations. The court stated that comparable sales prices were important to determining the value of the art. The IRS offered its own expert on the value of May Pole and Orpheus. Its expert employed a comparative market data approach. The court reduced the IRS's expert's valuation of May Pole from $2.1 million to $1,995,000 to take

account of the possible risk of cleaning. With respect to Orpheus, the court adjusted the IRS's appraiser's value to $375,000, since it was unclear as to who the actual artist was.

34. Koons v. Commissioner, 686 Fed.Appx. 779 (11th Cir. April 27, 2017)

Eleventh Circuit affirms adverse decision of Tax Court on Graegin loan

In this case, the Court of Appeals affirmed a decision of the Tax Court (T.C. Memo 2013-94) that denied a deduction for interest on a Graegin loan to the estate and accepted the valuation discount proposed by the IRS for LLC interests in the estate.

At John Koons' death in 2005, his revocable trust had a 46.94% voting interest and a 51.59% non-voting interest in CI LLC. CI LLC held the proceeds from the sale of the Pepsi distributorship business own by Koons and his family. The trust's LLC interests represented 50.5% of CI LLC. The net asset value of CI LLC on the date of Koons' death was $317,909,786. The other owners of CI LLC on the date of Koons' death were family members or trusts for their benefit.

In February, 2006, CI LLC loaned the revocable trust $10.75 million in exchange for a promissory note to assist in the payment of the federal and state estate taxes. The promissory note for the loan bore interest at 9.5% rate, with repayment deferred for eighteen years and then payment in 14 semi-annual installments of $5.9 million between August 31, 2024, and February 28, 2031. The terms of the loan prohibited pre-payment. As a result of these terms, the total interest on the loan for its term would be $71,419,497. The estate claimed this amount as a Section 2053 administration expense deduction on the federal estate tax return.

The Tax Court had determined that the revocable trust did not need to borrow the $10.75 million from CI LLC in order to pay the federal tax liability. It found that there were significant liquid assets in the trust, more than $19 million worth. When the trust borrowed the money in February, 2006, its voting interest had increased to 70.42% because of redemptions of some of the other members' interests, and the LLC had over $200 million dollars in highly liquid assets. The revocable trust had the power to force CI LLC to make a pro rata distribution to its members that it then could have used to pay the taxes. The court based its decision on the fact that the trust had other ways to access funds to pay the estate tax, making the loan unnecessary.

The loan that the Koons trust entered into was structured as a Graegin loan. In Estate of Graegin v. Commissioner, T.C. Memo. 1988-477, the assets of the estate consisted primarily of stock in a closely held corporation. After payment of state inheritance taxes and other expenses, the estate had $20,000 of liquid assets remaining. Rather than sell the stock in the closely-held corporation, the estate borrowed funds from a wholly-owned subsidiary of the closely-held corporation to pay the estate taxes. The term of the promissory note was 15 years and the interest rate was 15 percent simple interest (equal to the prime rate on the date of the loan). All principal and interest of the loan was to be repaid in a single balloon payment at the end of the term and the loan agreement contained a prohibition against early repayment. The estate deducted the amount of the single-interest payment due upon maturity of the note ($459,491) on the federal estate tax return as a cost of administration.

Because the amount of the interest was readily calculable and would not be a lesser amount (as it could be if prepayment was allowed), the Tax Court in Estate of Graegin held that the entire amount of the interest on the note was deductible as a cost of administration under Section 2053(a)(2).

The Internal Revenue Service issued a Litigation Guideline Memorandum dated March 14, 1989 in response to the decision in Graegin. The Memorandum states the Service's position that interest on indebtedness is deductible as an administration expense if the indebtedness is incurred to enable the estate to pay taxes due without selling non-liquid estate assets at a forced sales price. In order to be deductible, the interest must be certain to be paid, and the amount must be subject to reasonable estimation. The Service also stated that the transaction must have substance and that unusual financing techniques, such as unsecured loans, high rates of interest, and loans with long terms should receive close scrutiny especially if less expensive lending alternatives are available from third party sources.

Koons clearly stretched the limits of commercial acceptable loans with a high interest rate and significant deferral of payment. This almost certainly caused the IRS to closely scrutinize the estate tax return. An executor or trustee should be prepared to justify the need for a loan in order to pay estate taxes, and its reasonableness.

In those cases where there are not alternative sources of funds, such as an LLC that could have made distributions in Koons, taxpayers generally have been successful in deducting Graegin loan interest. An example is Estate of Purdue v. Commissioner, T.C. Memo 2015-249. The decedent's estate structured a Graegin loan with a family LLC of which it was member. The LLC had significant liquid funds, but the LLC terms required the consent of all the members to a distribution of the magnitude required by the estate, and one member refused to consent. The court allowed the interest deduction for the loan.

CHARITABLE GIFTS

35. Palmer Ranch Holdings Limited v. Commissioner, 812 F.3d 982 (11th Cir. 2016)

Court of Appeals reverses Tax Court's valuation of conservation easement for income tax charitable deduction purposes

Palmer Ranch, Inc. ("Palmer Ranch") owned undeveloped property in Sarasota County, Florida which was home to eagles and, as the Eleventh Circuit put it, "small urban animals of considerably less patriotic interest." To allow the eagles to reach their feeding grounds in Sarasota Bay, the property had a wildlife corridor from the eagles' nests on the property to the coast. Concern over the eagle nests, wildlife corridor and wet lands prevented Palmer Ranch from selling the parcel and an adjacent parcel for residential development. Palmer Ranch then donated a conservation easement on the property to Sarasota County. Palmer Ranch valued the parcel at $25,200,000 on the assumption that the highest and best use was residential development with a development of 360 dwelling units being a reasonable possibility.

In the Tax Court proceedings, Palmer Ranch insisted that the parcels' highest and best use was residential development which would permit between 2 and 5 units per acre for 164 to 410 units in total which should produce a value of $25,200,000. The IRS countered with a maximum highest and best use of 100 units and a value of $7,750,000. The Tax Court held in favor of Palmer Ranch on the methodology for determining the highest and best use of the parcel, but valued the property at $21,005,278 instead of $25,200,000.

On appeal, the Eleventh Circuit affirmed the Tax Court's determination of the highest and best use for the parcel in line with that proposed by Palmer Ranch. The Eleventh Circuit, however, reversed the Tax Court's valuation of $21,005,278. The Eleventh Circuit found that the Tax Court, in reaching a value of $21,005,278, had failed to look at the comparable sales provided by the appraisers for both the taxpayer and the IRS, but instead looked at a 2004 valuation of the parcel. The Tax Court's valuation was premised on an old appraisal as modified by monthly appreciation rates instead of on comparable sales.

The case was remanded to the Tax Court to either use the comparable sales analysis in determining the highest and best use value or explain its departure from the use of the comparable sales method.

36. RP Golf LLC v. Commissioner, T.C. Memo. 2016-80, aff'd 860 F.3d 1096 (8th Cir. June 26, 2017)

Tax Court sustains disallowance of $16.4 million deduction for 2003 donation of conservation easement on two private golf courses

RP Golf LLC ("RP Golf") developed two private golf courses in Missouri which were completed and placed into service between 2000 and 2003. Each golf course organized for profit private golf clubs and National Golf operated both of the golf clubs. Hillcrest Bank financed the original purchase of the property on which the golf courses were located and made a development loan to RP Golf. RP Golf, National Golf, and another related entity granted security interests in all the properties and executed a deed of trust. Earlier development financing was also obtained from Great Southern Bank which also secured its loans with a deed of trust.

On December 29, 2003, National Golf executed a conservation easement on the property. National Golf expressly reserved the right to use the property as a golf course. When National Golf executed the conservation easement on December 29, 2003, the property was subject to senior deeds of trust held by Hillcrest Bank and Great Southern Bank. Written consents subordinating the interests of the two banks were executed by bank officers on April 14, 2004, approximately 100 days after the execution of the conservation easement.

The IRS subsequently disallowed the entire income tax charitable contribution deduction for the conservation easement on the grounds that the creation of the conservation easement failed to satisfy the requirements for an income tax charitable deduction or that the donor failed to establish that the value of the easement was $16,400,000. The IRS then filed a motion for summary judgment asking the court to sustain its disallowance of the income tax charitable

deduction. In 2012, in RP Golf LLC et al. v. Commissioner, T.C. Memo. 2012-282, the court held that the charitable contribution did not have a charitable purpose within the meaning of Section of 170(h)(4)(A)(iii)(II) requiring a clearly delineated federal, state or local government conservation policy and that genuine issues of material fact remained concerning whether the requirements for a charitable contribution deduction had been met for 2003.

In this case, the court focused on the requirement under Section 170(h)(1) that, in order to have a qualified conservation contribution, the contribution is exclusively for conservation purposes. One requirement is that a contribution shall only be treated as exclusively for conservation purposes if the conservation purpose is protected in perpetuity. RP Golf argued that the conservation purpose of the donated property was protected in perpetuity because both banks had orally agreed to conveyance at the time of the creation of the easement and subsequently subordinated their interests to in writing in the subject property.

The court found that the evidence failed to establish that the oral consent agreements in December 2003 with the two banks regarding the subordination of their interests in the conservation easement property actually subordinated their interests. Only the written subordinations several months later did. Because the property described in the conservation easement was subject to pre-existing unsubordinated mortgages on the date of the grant, the easement was not granted in perpetuity. Consequently, the income tax charitable deduction was disallowed.

37. Carroll v. Commissioner, 146 T.C. No. 13 (2016)

Conservation easement fails to meet the perpetuity requirement of Section 170

In 2005, Husband and Wife contributed a conservation easement on a parcel of land to two charities. The conservation easement provided that, in the event that the conservation purpose was extinguished because of an unexpected change in circumstances surrounding the donated property, the donee organizations were entitled to a proportionate share of the extinguishment proceeds at least equal to the amount allowable as a deduction for federal income tax purposes over the fair market value of the property at the time of the contribution.

The court denied the income tax charitable deduction. Section 170(h) allows an income tax charitable deduction for a "qualified conservation contribution." A qualified conservation contribution requires that the contribution be exclusively for conservation purposes and that the conservation purposes must protected in perpetuity. Treas. Reg. § 1.170A-14(g)(6)(ii) provides that the conservation purpose of a contribution is not protected in perpetuity unless the contribution gives rise to a property right immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift bears the value of the property as a whole at that time. Accordingly, when a change in conditions gives rise to the extinguishment of a perpetual conservation restriction, the donee organization on a subsequent sale, exchange or involuntary conversion of the subject property must be entitled to a portion of the proceeds at least equal to the proportionate value of the perpetual conservation restriction. Here, because the easement

provided that the value of the contribution for purposes of determining the charity's rights to the extinguishment proceeds was the amount of the donor's allowable deduction rather than fair market value of the easement, it did not comply with the requirements of the Treasury Regulations and the conservation purpose was not protected in perpetuity as required. Consequently, the income tax charitable deduction was denied and accuracy related penalties were imposed.

38. Revenue Procedure 2016-42, 2016-34 I.R.B. 269 (August 9, 2016)

IRS issues sample provision to permit a charitable remainder annuity trust to qualify even if it does not meet the probability of exhaustion test

One requirement of a charitable remainder annuity trust is that it must pass the "probability of exhaustion test." This test holds that, if there is a greater than five percent probability that the payment of the annuity will defeat the charity's interest by exhausting the trust assets by the end of the term of the charitable remainder annuity trust, then the possibility that the charitable transfer will not become effective is not so remote as to be negligible. A charitable deduction is only allowed if the possibility that the charitable gift will not become effective is so remote as to be negligible.

Low interest rates in recent years have greatly limited the use of the charitable remainder annuity trust as an effective charitable giving vehicle. The Service notes in this revenue procedure that, in May 2016, the Section 7520 rate underlying the valuation tables is 1.8%. At this interest rate, the sole life beneficiary of a charity remainder annuity trust that provides for the minimum allowable annuity of 5% of the initial fair market value of the trust assets must be at least 72 years old at the creation of the trust to pass the test. The Section 7520 rate has not exceeded the minimum 5% annuity payout since December of 2007 which has necessitated testing for the probability of exhaustion for every charitable remainder annuity trust created since that time.

The sample provision, which applies to a single life charitable remainder annuity trust, but which can be modified for a charitable remainder annuity trust which has more than one private beneficiary, provides an alternative to satisfying the probability of the exhaustion test. The provision will cause the early termination of the charity remainder annuity trust, followed by an immediate distribution of the remaining trust assets to the charitable beneficiary. It provides for early termination of the trust (and thus the end of the ability to make any more annuity payments to the private beneficiary or beneficiaries) on the date immediately before the date on which the annuity payment would be made, if the payment of that annuity amount would result in the value of the trust corpus, when multiplied by a specified discount factor, being less than ten percent of the value of the initial trust corpus.

The revenue procedure is affective after the date of the revenue procedure. A charitable remainder annuity trust that contains a provision similar to the sample provision contained in the revenue procedure will not necessarily be disqualified, but will also not be assured of the favorable treatment.

39. Letter Ruling 201636043 (Issued May 18, 2016; Released September 2, 2016)

Exchange of assets by charitable remainder trust for units in a charity's endowment does not generate unrelated business taxable income

This ruling involved a standard charitable remainder unitrust. Donor was entitled to an annual unitrust payment. The remainder interest was to be distributed to Charity as the remainder beneficiary. Charity's primary purpose was to support a particular religious community and its religious, health, social service and educational institutions. The Charity maintained an endowment through an investment partnership with other tax-exempt organizations. The investment partnership held a widely diversified portfolio. Charity paid out a certain amount of its unrestricted endowment fund each year to fund its operations.

Charity would become sole trustee of the charitable remainder unitrust prior to the exchange for assets for units. To allow the charitable remainder trust to earn a return equal to that realized by the endowment fund, Charity and trust proposed to enable the trust to participate indirectly in the return on Charity's endowment by entering into an agreement that will provide for the exchange of trust assets for units in the endowment. The trust will have no ownership interest in the underlying assets of the endowment or the investment partnership. The trust will only have the right to review the payout computation.

The Service ruled that the payments from Charity to the trust would reflect ordinary income and not take on the character of the underlying assets. It noted that the trust would not acquire any ownership interest or rights in the assets of the endowment by investing its assets in units and holding the units. Instead, units would represent a mere contractual right to receive periodic payments from the endowment as determined by Charity. In addition, the investment of the units would not be characterized as a partnership for federal income tax purposes. The investments in the units with respect to the endowment did not give the charitable remainder unitrust any ownership interest in the underlying assets of the endowment. Even though some of the assets in the endowment were debt-financed or otherwise treated as producing unrelated business taxable income to Charity under Section 512, the character of the assets in the endowment would not determine the character of the charity's payments to the trust. Consequently, any debt financing associated with an underlying asset in the endowment was irrelevant in determining whether the charitable remainder unitrust had any unrelated business taxable income. In addition, any redemption of the units will not be characterized as unrelated business taxable income.

40. Letter Rulings 201729013 and 201729014 (Issued April 11, 2017; Released July 21, 2017)

IRS finds no unrelated business taxable income with respect to investment of charitable remainder trust in endowment units of College

These are parallel letter rulings. The first deals with the consequences to a College indirectly of investing the assets of a charitable remainder trust in the College's endowment. The second deals with the consequences to the charitable remainder trust.

In Letter Ruling 201729013, the College was a tax-exempt educational institution and the College's endowment was managed by the College's Trustee Committee on Investment. The trust was a straight charitable remainder unitrust described in Section 664(d)(2). The College was the sole trustee of the charitable remainder trust and, in that capacity, was the legal owner of the assets of the trust. The College was also the sole remainder beneficiary of the trust. The College did not charge any fee for the management of the trust. It may recover its actual costs of administering the trust as a charge against the trust. The assets of the charitable remainder trust were managed by an outside investment firm and the investment returns had been lower than the return on the endowment of the College. To improve this, the College wanted to enable the charitable remainder trust to participate in the return on the endowment.

The College proposed to create a contractual obligation under which the College would issue a contract right to the charitable remainder trust for its endowment units. The value of the units, both at the time of acquisition and at the time of redemption, would be based on the value of all underlying investment assets held in the endowment. Each unit would give the charitable remainder trust the right to receive periodic payments equal to the number of units owned multiplied by the same spending rates that the College established for the endowment. This would allow the trust to receive an investment return equal to that of the endowment. The trust would treat payouts to its beneficiaries up to the endowment spending amount as ordinary income regardless of the character of the underlying income of the endowment. The charitable remainder trust in this letter ruling was representative of a number of charitable remainder trusts of which the College was the trustee and the sole remainder beneficiary.

The IRS ruled that the contractual arrangement under which the College would issue units to the trust, make payments on the units, and be reimbursed to cover the costs applicable to the management of the endowment or administration of the trust, would not generate unrelated business taxable income to the College. This result would apply to this particular charitable remainder trust or any other charitable remainder trust for which the College had or would have the sole charitable interest and for which the College would be the trustee.

The IRS distinguished the entity in this letter ruling from the entity described in Revenue Ruling 69-528, 1962-2 C.B. 127. That Revenue Ruling describe an organization that was formed to provide investment services on a fee basis exclusively to tax exempt organizations. That organization received funds from unrelated exempt organizations and invested the proceeds. The Service ruled in Revenue Ruling 69-528 that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for a profit and that the activity will constitute an unrelated trade or business even if the services were regularly provided by one tax-exempt organization for other tax-exempt organizations. In the first letter ruling, the College was distinguishable from the entity described in Revenue Ruling 69-528. The College would not charge any fees managing the trust assets and it would only recover the actual cost of managing endowment as a charge against the endowment and any costs of administering the trust as a charge against the trust. Since the College would receive no income from providing

management services to the trust, the services provided would not generate any income that could be characterized as unrelated business taxable income within the meaning of Section 513.

In Letter Ruling 201729014, the IRS held that the investment by the charitable remainder trust in the units would not give the trust any ownership interest or rights in the assets of the endowment. As a result, the exchange of assets currently held by the trust for units with respect to the College's endowment, the receipt of payments with respect to the units, and the holding and redemption of the units would not generate unrelated business taxable income to the trust. This was because Section 512(b)(1) excludes income from certain passive investments from being treated as unrelated business income for exempt organizations including charitable remainder trusts. The circumstances of the charitable remainder trust indicated that the investment in the College's endowment would be a passive investment. The trust's investment in units and holding units would not give the trust any ownership interest or rights in the endowment. The trust would not have any power of control or direction with respect to the endowment. Instead the units represented a mere contractual right to receive periodic payments from the endowment, as determined by the College.

41. Letter Rulings 201714002 and 201714003 (Issued December 21, 2016; Released April 7, 2017)

IRS addresses tax consequences of termination of charitable remainder unitrusts

In each of these two letter rulings, A formed a trust that was intended to qualify as a Charitable Remainder Unitrust ("CRUT"). A and B served as co-trustees of the trust.

Under the trust agreement, the trust was required to make quarterly payments to A for the shorter of A's life or twenty years. If A died prior to the expiration of the 20-year term, the payments would be made for the balance of the 20-year term to B or B's designated successor. At the end of the 20-year term, the remaining assets of the trust would be distributed to X or a subsequently named charity.

This trust was a net income only CRUT which paid the lesser of the unitrust percentage or the actual income earned by the trust each year. The CRUT contained make-up provisions so that in any year in which the actual income of the trust exceeded the designated unitrust percentage, the excess could be used to make up deficiencies in payouts from prior years.

Because the assets of the CRUT consisted primarily of low basis non-dividend paying stocks, A and B engaged C to provide financial and estate planning advice. C recommended that A and B engage D for legal advice on estate planning and charitable giving. C and D ultimately recommended that A create a Charitable Remainder Unitrust and that A should transfer low basis capital assets in the trust in order to avoid the imposition of capital gains taxes on the subsequent sale of those assets by the trust. A and B were advised that this arrangement would allow the CRUT to sell the stock in the future without incurring capital gain taxes and that the trust would serve both as an estate planning vehicle and a charitable giving vehicle.

According to the ruling request, D represented to A and B that no gift taxes would be due upon creation of the trust because the gift would be incomplete as to the successor recipients at the time. To achieve this result, A would retain the right to change the successor recipients. However, when D drafted the trust agreement, D failed to reserve A's right to change the successor recipients. As a result, the interests of the successor recipients at the time the trust agreement was executed was complete and the gift to the successor recipients become complete, causing gift taxes to be due and owing. However, when gift tax returns were prepared by A's accountant, the accountant relied on the advice given by D, the lawyer, that no gift tax was owed.

The ruling request noted that C, the financial adviser, represented to A and B that the trust assets would generate a specific return and that the trust would receive a guaranteed return of a specific percentage on the fair market value of the trust assets during A's lifetime or the 20-year term of the trust. The assets of the CRUT were invested in annuities and insurance products that C was licensed to sell. These types of investments made it difficult for the trust to generate the promised annual return and the trust never received the promised return. During the years that the unitrust amount was payable to A before A's death, the trust never generated sufficient income, without including capital gain, to meet the represented payout. Based on the erroneous advice provided by C and D, the trustees of the trust the trustees erroneously determined the amount to be distributed to the unitrust beneficiary in Year 1, Year 2 and Year 3 by improperly including capital gains in the trust income to be distributed.

In addition, based on the erroneous advice of C and D that the CRUT was not subject to estate tax in A's estate, A added additional assets to the trust in the subsequent years after the initial funding of the trust. The purpose of these additions was to further reduce the assets in A's taxable estate.

After A's death within the 20 year term of the trust, B became the successor unitrust recipient and the sole trustee. Upon realizing the problems with the CRUT, B petitioned the court to reform the trust agreement. The charitable beneficiary of the trust and the state attorney general objected to the reformation and B's first petition was dismissed. B submitted a second petition for reformation which was dismissed without prejudice.

B then filed a third petition to either reform or terminate the trust. The court in ruling on the third petition declared the trust as void ab initio. The court's ruling was contingent on the trust receiving a favorable ruling from the Internal Revenue Service that provided that the declaration would not result in additional federal income tax consequences. If the trust did not receive a favorable rendering from the Service that no income tax was owing, the trustee was to file a statement to that effect with the court and upon such filing, the trust would be declared to be terminated and, after payment of all amounts due and owing to the Internal Revenue Service and the State Department of Revenue from the assets of the trust, the trust would be distributed to a unitrust income recipient. B died after the date that the court order was issued and B's surviving spouse, E, was successor trustee and the unitrust recipient.

The IRS first ruled that, taking into account both Revenue Ruling 80-58, 1980-1 C.B. 181 and Revenue Procedure 2016-3, 2016-1 I.R.B. 126, it was unable to provide a favorable ruling that the court's declaration the trust was void ab initio would have no federal income tax consequences. Revenue Ruling 80-58, which did not involve a trust, stated that the legal concept

of rescission refers to the abrogation, cancelling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have had had no contract been made. However, the annual accounting period principle requires the determination of income at close of each taxable year without regard to subsequent events. In Revenue Proceeding 2016-3, the Service stated that the question of whether a completed transaction may be rescinded for income tax purposes is an area in which rulings will not be issued.

As a result, the court's order would not void the trust ab initio and would default to the termination of the trust. The ruling then held that the trust was not to be respected as a CRUT because the trust did not function exclusively as a charitable remainder trust throughout its existence, since it distributed amounts in excess of its annual net income to the income beneficiary.

The Service then ruled that the trust would be a split interest trust subject to Section 4947(a)(2) and thereby treated as a private foundation for purposes of the imposition of certain excise taxes. These included the tax on taxable expenditures for distributions for non-charitable purposes and taxes for self-dealing for making distributions to E who was a disqualified persons if distributions were made prior to the termination of the trust's private foundation status. The trust would need to file income tax returns and pay any income tax owed plus interest and penalties for any open years.

42. McGrady v. Commissioner, T.C. Memo 2016-233

Taxpayers overvalued donated land by $1 million but did not face penalties for overvaluation

On their federal income tax return for 2007, Husband and Wife reported a $4.7 million non-cash charitable contribution. This contribution comprised two distinct gifts, which were components of a complex conservation plan in Bucks County, Pennsylvania. Petitioners donated a qualified conservation easement on their 25 acre homestead property to the township in which they lived (Parcel B). They donated to a tax exempt conservation organization a fee simple interest in an adjoining 20 acre parcel of undeveloped land (Parcel A). Unable to use the income tax charitable deduction fully in 2007, Husband and Wife claimed carryover charitable contribution deductions for 2008–2011.

The IRS disallowed the income tax charitable deductions in full. It asserted that Husband and Wife lacked donor intent that they failed to satisfy various reporting requirements, that they overvalued the donated property, and that they received benefits in exchange for the gifts. The IRS also imposed accuracy related penalties.

On Husband and Wife's 2007 federal income tax return, they valued the donation of the parcel to the charity at $2.35 million dollars and the donation of the conservation easement to the township also at $2.35 million dollars. They included appraisals of both properties completed by Vincent D. Quinn. The court found that Quinn was an expert in the valuation of residential real estate and had more than 40 years of experience appraising commercial and residential real estate

including subdivisions. Husband and Wife offered a second appraiser who had 40 years of appraisal experience and also appraised numerous properties in Bucks County. He determined the fair market value of the Parcel A property and Parcel B easement was $2,160,000 and $1,460,000 respectively. He also determined that the fair market value of a buy back right was $221,700 and an access easement was no more than $12,000. IRS offered an appraiser who determined that the fair market value of Parcel A was $920,000 and that the fair market value of Parcel B was between $190,000 and $390,000. The court did its own valuation calculations and found that the fair market value of parcel A was $2,191,896 and the fair market value of parcel B was $1,491,896. After making an allowance for the buyback right, the net charitable income tax contribution was $3,654,792.

The court then declined to impose accuracy related penalties because Husband and Wife had relied in good faith upon an appraisal done by reputable appraiser.

43. 15 West 17th Street LLC v. Commissioner, 147 T.C. No. 19 (2016)

Income tax charitable deduction for gift of conservation easement denied for lack of contemporaneous written acknowledgment

On September 2005, the 15 West 17th Street LLC purchased a property consisting of two parcels in New York City for $10 million. The northern parcel contained a building which the LLC initially planned to demolish. However, the Greenwich Village Society for Historic Preservation petitioned the New York City Landmarks Preservation Commission to designate the building as a landmark which petition was granted.

On December 20, 2007, the LLC executed a historic preservation deed of easement in favor of the Trust for Architectural Easements. The deed granted the Trust a perpetual conservation easement over the north parcel of the property including the building which had received historic landmark status. The contribution of the easement was completed for federal tax purposes in 2007. On May 14, 2008, the Trust sent the LLC a letter acknowledging receipt of its easement. The letter did not state whether the Trust had provided any goods or services to the LLC or whether the Trust had otherwise given the LLC anything of value in exchange for the easement.

The LLC secured an appraisal concluding that the fair market value of the property before placement of the easement was $69,230,000. The appraisal thus opined that the property, which was acquired for $10 million in 2005, had risen in value by almost 600 percent in two and a half years. The appraisal then opined that the property was worth only $4,740,000 after the donation. Thus, the conservation easement reduced the property value by $64,490,000.

When the LLC filed its 2007 partnership income tax return, it deducted the $64,490,000 value of the easement. The LLC included with its return a copy of the appraisal report, a copy of the Trust's May 14, 2008 letter, and the Form 8283, Noncash Charitable Contributions, executed by the appraiser and by the representative of the Trust.

On August 19, 2008, the Trust filed its Form 990 for 2007. On that return the Trust did not report receipt of a charitable contribution from the LLC. Nor did it report whether it provided any goods or services to the LLC in exchange for the easement.

The IRS audited the partnership return of the LLC. The IRS determined that the value of the easement was substantially less than the $64,490,000 claimed on the return and determined penalties for gross valuation misstatement. On June 16, 2014, the Trust prepared an amended Form 990 for 2007. On the amended Form 990, the Trust added one sentence to the description of its statement of program service accomplishments. It stated, "one of the New York donations received during 2007 included the donation by 15 West 17th Street LLC of a historic preservation deed of easement. It also stated that the Trust provided no goods or services to 15 West 17th Street LLC in consideration for its donation of the historic preservation deed of easement.

Under Section 170(f)(8)(A), in order to substantiate a charitable contribution deduction of $250 or more, a taxpayer must secure and maintain in its file a contemporaneous written acknowledgment, which must state, among other things, whether the donee provided the donor with any goods or services in exchange for the gift.

The substantiation requirements do not apply to a contribution if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe that includes the information required in a contemporaneous written acknowledgment. To date, the Secretary has not issued regulations to implement the donee reporting regime that is an alternate to contemporaneous written acknowledgment.

The court held that the need for a contemporaneous written acknowledgment meeting the requirements of the Code and regulations to receive an income tax charitable deduction applied to this gift and that the alternate was not available because the Treasury Department had yet to issue the regulations to which the statute referred.

44. RERI Holdings LLC v Commissioner, 149 T.C. No. 1 (July 3, 2017)

Tax Court denies income tax charitable donation for gift of LLC interest

RERI Holdings I, LLC ("RERI") donated an LLC interest that was subject to a prior estate for years through 2020 to the University of Michigan in August 2003. RERI had purchased the LLC interest in March 2002 for $2,950,000. However, on its 2003 partnership return, RERI claimed an income tax charitable contribution deduction of $33,019,000 for the transfer to University of Michigan. The income tax return for RERI contained a Form 8283 Appraisal Summary which disclosed the March 2002 purchase, but left blank the place for "donor's cost or other adjusted basis". Two years after receiving the gift, the University of Michigan sold the LLC interest for $1,940,000 to another LLC indirectly owned by RERI.

The IRS disallowed RERI's deduction entirely on the grounds that the transaction was a sham for income tax purposes or lacked any economic substance. RERI moved for summary judgment in the Tax Court on the grounds that neither the sham transaction doctrine nor the lack of

economic substance doctrine applied to the charitable gift. The Tax Court held that both the sham transaction doctrine and the lack of economic substance doctrine applied and denied summary judgment to RERI.

The IRS then moved for partial summary judgment that the actuarial tables under Section 7520 could not be used to value the future interest that RERI contributed to the University of Michigan and that RERI had failed to substantiate the value of its contribution with a qualified appraisal. The court denied summary judgment to the IRS on its motion for partial summary judgment.

The court at trial noted that the omission of basis from the Form 8283 violated the substantiation rules because the cost basis would have alerted the IRS to a potential overvaluation of the charitable gift. As a result, the omission cannot be excused on grounds of substantial compliance. The court then noted and found that the actuarial factors under Section 7520 did not apply. It also found that the fair market value of the property contributed to the University of Michigan on the date of the contribution was $3,462,886 and that the gross valuation misstatement penalty would apply.

45. 310 Retail, LLC v. Commissioner, T.C. Memo 2017-164

Deed of easement constitutes contemporaneous written acknowledge for charitable income tax deduction for gift of conservation easement

This case was before the Tax Court on cross motions for partially summary judgement as to whether a contemporaneous written acknowledgement for a charitable gift was provided. The court noted that the Form 8283 filed by 310 Retail, LLC when the gift was made did not meet the requirements of a contemporaneous written acknowledgement because it failed to include any information on whether the Landmark Preservation Council to which conservation easement was deeded had supplied 310 Retail, LLC with any goods or services. The July 2009 letter contained that information but it was not contemporaneous.

310 Retail, LLC had filed an amended Form 990 for the tax year that disclosed the façade easement and stated that no goods or services provided exchanged therefore. However, the court held that the Form 990 did not meet the requirements for contemporaneous written acknowledgment since the regulations as in force did not provide for an alternative method to a contemporaneous written acknowledgment.

However, the court found that a deed of easement may qualify as a contemporaneous written acknowledgement if it contains the required information. The court noted that in Averyt v. Commissioner, T.C. Memo 2012-198, the granting provisions stated the donor conveyed a perpetual conservation easement in consideration with the mutual covenants, its terms, conditions and restrictions set forth and as an absolutely unconditional gifts subject to all manners of record. It also stated that this instrument sets forth the entire agreement of the parties with respect to the easement and supersedes all prior discussions, negotiations and understanding of the agreements relating to the easement all which are merged herein. That deed qualified as a contemporaneous written acknowledgement. As a result, the merger clause, read in connection with the other statements deed of easement, supplied the affirmation that is required for a

contemporaneous written acknowledgement that no goods or services were received in exchange for the contribution. The reasoning in Averyt was followed in RP Golf, LLC, T.C. Memo 2012-282.

The court found that the deed of easement in this case was similar in all materials respects to the deed in RP Golf, LLC and stated that the deed would qualify as contemporaneous written acknowledgement.

46. Big River Development, LP v. Commissioner, T.C. Memo 2017-166

Deed of easement constitutes contemporaneous written acknowledge of charitable gift

This case involves a charitable contribution deduction claimed by Big River Development, LP for a conservation easement. The court had previously held that deed of easement may constitute a contemporaneous written acknowledgment in 310 Retail, LLC v. Commissioner, T.C. Memo 2017-164; RP Golf, LLC v. Commissioner, T.C. Memo 2012-282; and Averyt v. Commissioner, T.C. Memo 2012-198.

In this case, Big River acquired a property in Pittsburgh, Pennsylvania and began converting the building into a luxury apartment complex. On January 12, 2005, Big River executed a deed of historic preservation conservation easement to the Pittsburgh History and Landmarks Foundation over the façade of the building. The deed of easement noted that Big River was granting to the Pittsburgh History and Landmarks Foundation the façade easement pursuant to Section 170(h) of the code. The deed recited the obligations and would be deemed to run as a binding servitude with the property in perpetuity. It noted that the foundation would monitor Big River's compliance with the easement restrictions. It also noted that Big River was paying the foundation a fee of $93,500 to endow the monitoring of the easement.

Big River secured an appraisal that valued the façade easement at $7.14 million and claimed a $7.14 million charitable contribution deduction on its income tax return. While Big River attached a Form 8283 executed by the appraiser and by the foundation's president, this document contained no statement as to whether the foundation had provided any goods or services to Big River in exchange for its gift. Two years after the gift was made, the foundation supplied Big River with a letter stating that the foundation had not provided any goods or services in exchange for the contribution.

In 2009, the IRS proposed to disallow the charitable contribution deduction because there was no contemporaneous written acknowledgement. In this summary judgment proceeding, the court noted that the requirement of a contemporaneous written acknowledge is a strict one when there is a gift of $250 or more. The Form 8283, while contemporaneous, did not include the statement as to whether the Foundation had provided any goods or services in exchange for the gift. The letter provided by the foundation in 2007 included that statement that it was not contemporaneous. The court however then found that Big River received a contemporaneous written acknowledgement in the form of the deed of easement. It noted that the deed of easement was property executed by the foundation's president contemporaneously with the gift.

To the extent that the foundation's monitoring activities constituted the rendering of services to Big River, the deed of easement provided a description and a good faith estimate of the value of those services. Finally, because the deed of easement explicitly stated that it represented the parties' entire agreement, it negated the receipt by Big River of any other goods or services from the foundation. As a result, the deed of easement constituted a contemporaneous written acknowledgement meeting the requirements of Section 170(f)(8)(B).

47. <u>Ohde v Commissioner</u>, T.C. Memo, 2017-137

Husband and Wife denied income tax charitable contribution deduction for over 20,000 items donated to Goodwill Industries in 2011

Mark and Rose Ohde claimed an income tax charitable deduction of $145,250 for over 20,000 items deducted to Goodwill Industries in 2011. This included 3,454 items of clothing, 115 chairs, 36 lamps, 22 bookshelves, 20 desks, 20 chest of drawers, 16 bed frames, 14 filing cabinets, and 3,153 books. For each delivery, Goodwill gave them a one-page, generic receipt stating no quantities or values.

For 2007 through 2010, the Ohdes had claimed income tax charitable deductions for non-cash charitable contributions aggregating $292,143. For 2012 and 2013, the Ohdes claimed income tax charitable deductions for non-cash charitable contributions aggregating $104,970. The Tax Court found none of the taxpayers' testimony creditable, disallowed the entire deduction, and sustained an accuracy-related penalty.

Ron Aucutt has offered the following reflection on the Ohde case:

Mark and Rose Ohde

Drove down the road,

And with a load

Goodwill bestowed.

But what they sowed

Would soon implode,

And, per the Code,

Big bucks they owed.

48. Partita Partners LLC v. United States, ___ F.Supp.3d ___ (S.D.N.Y. July 10, 2017)

Valuation misstatement penalty may be imposed even though the claimed charitable deduction was denied on other grounds

In 2008, Partita Partners LLC claimed a federal income tax deduction of $4,186,000 for a donation of a preservation easement in the facade of a building owned on the Upper East Side of New York City. The building was constructed in the 1870s and was part of the Upper East Side Historic District since 1981. Partita made its donation to the Trust for Architectural Easements and, as part of its deed of easement, reserved 2,700 square feet for future development rights. The IRS disallowed the deduction in 2014 and assessed a forty percent underpayment penalty against Partita asserting that Partita made a gross valuation misstatement. In the alternative the IRS argued that a twenty percent underpayment penalty on grounds of negligence, substantial understatement of income tax, or a substantial valuation misstatement should be imposed under Section 6662.

Partita moved that the taxes should be readjusted to recognize the charitable deduction of the facade easement donation and that no underpayment penalty should be imposed. On October 15, the court granted a motion for partial summary judgment filed by the United States and held that the donation of the facade easement did not preserve the building's entire exterior as required for the income tax charitable deduction and therefore Partita was ineligible for the $4,186,000 dollar deduction that it claimed.

The only remaining issue was the challenge to the underpayment penalty. Here, the court denied the plaintiff's motion for partial summary judgment. It noted that the language of Section 6662(d) and authority in the Second Circuit permits the application of a penalty when the deduction is also disallowed on other, separate grounds. It cited United States v. Woods, 134 S. Ct. 557 (2013) for the proposition that where transactions have no legitimate business purpose or economic substance and the IRS denied deductions in their entirety, the imposition of a valuation misstatement penalty has been upheld. Woods resolved a circuit split on this issue.

49. Gardner v. Commissioner, T.C. Memo 2017-165

Tax Court upholds denial by IRS of most of charitable deduction claimed by donor for gift of big game specimens

A reader of this opinion immediately knew that the taxpayer was unlikely to receive a favorable opinion when the court opened its opinion by stating that "[t]o paraphrase Ernest Hemingway, there is no hunting like the hunting for a tax deduction". Paul Gardner was an avid big game hunter who in 2006 opted to downsize his trophy big game specimen collection by donating less desirable specimens in the collection to the Dallas Ecological Foundation. Relying on an appraisal, he claimed an income tax charitable deduction of $1,425,900.10. Because of the percentage limitations on the income tax charitable deduction, Gardner exceeded the maximum allowable charitable deduction for 2006 and carried the balance of the deduction over to 2007 and 2008.

In auditing Gardner's 2006 to 2008 income tax returns, the IRS determined that the value of the specimens contributed was at most $163,045. As a result, the IRS determined additional tax owed of $137,647 for 2007 and $274,228 for 2008.

Gardner used an appraiser recommended by the Dallas Ecological Foundation to appraise the specimens for purposes of the income tax charitable deduction. After a conversation with the appraiser, Gardner chose a total of 177 specimens from his collection for donation to the ecological foundation. The court noted that none of the specimens was of record quality. The appraiser's report used the replacement cost method to determine the fair market value of these items. The appraiser estimated what it would cost to replace each item with a specimen of like quality by tallying up the expected out of pocket expenses for traveling to a hunting site, being on safari for the requisite number of days, killing the animal, removing and preserving the given body parts, shipping the specimen back to the United States, and defraying the taxidermy costs of stuffing, mounting, and otherwise preparing the item for display. He considered factors such as the prorated unit cost, shipping fees, and taxidermy fees. For example using his replacement cost approach, the appraiser valued the tanned skin of a Central Asian sheep at $75,600 on the theory that it would cost that much to bag another similar sheep. A mount of the horns of a desert big horn sheet was valued at $56,800. At the time that he drafted his appraisal, the appraiser knew that Gardner intended to claim an income tax charitable deduction for the 177 specimens. After Gardner transferred the 177 specimens to the Dallas Ecological Foundation, the Dallas Ecological Foundation apparently put the donated specimens in storage and subsequently either sold them or gave them away.

The IRS offered an expert in taxidermy as its appraiser. The IRS's appraiser used the market approach to determine the fair market value of the specimens. The IRS's appraiser also consulted market data from auction houses, online auction sites, and other websites specializing in hunting specimens. The IRS's appraiser determined that the aggregate fair market value of the 177 specimens was $41,140 if there were no defects in the specimens. However, he also observed defects in many of the specimens and reduced his appraised value as a result of those defects to $34,240.

Gardner, at trial, did not use the appraiser who had appraised the specimens for purposes of the income tax charitable deduction. Instead he presented two experts. One was a technical consultant at the Museum of Natural History and the second was an art historian and appraiser, neither of whom assigned a dollar value for the 177 specimens. Instead, they only were witnesses to support the use of the replacement cost as the proper valuation methodology. Because Gardner failed to seriously challenge the IRS's appraisal and introduced no evidence of market prices, the court accepted the $163,045 value that the IRS allowed in notice of deficiency and permitted and income tax charitable deduction for that amount.

50. Letter Rulings 201730012, 201730017, and 201730018 (Issued May 1, 2017; Released July 27, 2017)

Conversion of a charitable lead annuity trust from a non-grantor trust to a grantor trust would not have adverse income tax consequences for grantor and would not result in an income tax charitable deduction to grantor in year of conversion

These three letter rulings dealt with the same fact situation. Grantor created a charitable lead annuity trust ("CLAT") for a term of years. The CLAT was established as a non-grantor trust for income tax purposes and each year, the CLAT received an income tax charitable deduction pursuant to Section 642(c)(1) for the amounts of gross income included in the annual annuity paid to the charity.

The CLAT sought to convert from a non-grantor trust to a grantor trust by an amendment to the CLAT to allow the grantor's sibling to act as a "substitutor" with the power to acquire and reacquire trust principal by substituting property of equivalent value in a non-fiduciary capacity pursuant to Section 675(4)(C). In connection with the conversion, the grantor sought the following rulings:

1. The conversion of the CLAT from a non-grantor trust to a grantor trust would not be a taxable transfer of property held by the trust to the grantor as settlor for income tax purposes and result in adverse income tax consequences to the grantor;

2. The conversion of the CLAT from a non-grantor trust to a grantor trust was not an act of self-dealing; and

3. The conversion of the CLAT from a non-grantor trust to a grantor trust would not result in an income tax charitable deduction for the grantor in the year of the conversion.

The IRS ruled that the conversion of the CLAT from a non-grantor trust to a grantor trust was not a transfer of property to the grantor from the CLAT and therefore would not result in adverse income tax consequences to the grantor. This runs counter to the thinking of some commentators who believe that that the conversion should be treated as a transfer to the person who will now be treated as the owner for income tax purposes.

The IRS then ruled conversion of the trust from a non-grantor trust to a grantor trust was not an act of self-dealing under Section 4941 because the person who would be named to have a power of substitution within the meaning of Section 675(4) was a sibling of the grantor. Section 4947(a)(2) applies Section 4941 to charitable lead trusts which, in turn, imposes an excise tax on acts of self-dealing between a disqualified person and the charitable lead trust. The substitutor was not a disqualified person because a sibling of the grantor is not treated as a family member in Section 4946. Consequently, the conversion of the trust would not be an act of self-dealing because no disqualified person was involved.

The IRS also held that the grantor not be entitled to take an income tax charitable deduction because the conversion was not a transfer of property from the non-grantor trust to the grantor trust for income tax purposes.

The Service expressed no opinion as to whether the proposed conversion would have any gift tax consequences to the grantor or as to whether an act of self-dealing might occur upon the exercise of the power to substitute assets.

51. Estate of Sower v. Commissioner, 149 T.C. No. 11 (2017)

IRS can review estate tax return of first spouse to die and reduce the amount of the deceased spousal unused exclusion amount reported on that return

Husband died in 2012 and Husband's estate reported a deceased spousal unused exclusion (DSUE) amount and elected portability. In 2013, the IRS sent Husband's estate a letter stating that the return had been accepted as filed. Wife died in 2013 and Wife's estate claimed the DSUE amount reported by Husband's estate on Wife's estate tax return. As part of an examination of the estate tax return filed by Wife's estate, the IRS also examined the estate tax return filed by Husband's estate and reduced the amount of the DSUE amount by the amount of taxable gifts made by Husband but did not determine or assess a deficiency against Husband's estate. However, the IRS determined an estate tax deficiency against Wife's estate because of the reduction in Husband's DSUE amount. Wife's estate filed a petition in which it made several arguments regarding why the IRS should be prohibited from examining the estate tax return filed by Husband's estate to determine the proper DSUE amount allowable to Wife's estate.

During their lifetime, Husband and Wife each gave away $997,920 in taxable gifts. All the gifts were given between 2003 and 2005. When Husband died in 2012, his estate filed an estate tax return reporting no estate tax liability and reported taxable gifts of zero, but included $945,420 in taxable gifts on the worksheet provided to calculate the taxable gifts to be reported on the return. Husband's estate reported a DSUE amount of $1,256,033 and elected portability as the decedent allowed the surviving spouse to use it.

On November 1, 2013, the IRS issued an initial Letter 627, estate tax closing letter to Husband's estate. The Letter 627 showed no estate tax liability for Husband's estate. The Letter 627 also stated the return is had been accepted as filed and further stated: "[the Commissioner] will not reopen or examine this return unless *** notified] of changes to the return or there is: (1) evidence of fraud, malfeasance, collusion, concealment or misrepresentation of material fact; (2) a clearly defined substantial error based upon an established Internal Revenue Service position; or (3) a serious administrative error."

Wife died on August 7, 2013. Her estate filed a timely return claiming the DSUE of $1,256,033.00 from Husband's estate. Initially her estate reported and paid an overall estate tax liability of $369,036. Three months later the estate paid an additional $386,424 in tax and interest to correct a mathematical error on the original return. As with Husband's estate, Wife's estate did not include the lifetime taxable gifts on the return, but rather than reporting zero in gifts as on Husband's estate tax return, it left the entry blank on Wife's estate tax return.

In February 2015, the IRS began its examination of the estate tax return filed by Wife's estate. In connection with that examination, the Commissioner also opened an examination of the return filed by Husband's estate to determine the proper DSUE amount available to Wife's estate. On

March 25, 2015, the IRS sent a letter and draft revised report showing an adjustment to the amount of Husband's lifetime gifts. On July 20, 2015, the IRS sent a second estate tax closing letter to Husband's estate. Nothing in the second closing letter for Husband's estate suggested that the IRS requested any additional information from or determined any additional liability for Husband's estate.

As a result of the examination of the return filed by Husband's estate, the IRS reduced the DSUE available to Wife's estate from $1,256,033 to $282,690. The IRS also adjusted Wife's taxable estate by the amount of her lifetime taxable gifts. These adjustments resulted and increased the estate tax liability for Wife's estate by $788,165. Wife's estate made the following arguments.

First, it argued that the estate tax closing document should be treated as a closing agreement under Section 7121 and that the IRS should be estopped from reopening Husband's estate by the text of the document.

Second, Wife's estate argued that the examination that took place after the IRS had sent the first estate tax closing document was an improper second examination.

Third, the estate argued that the effective date of Section 2010(c)(5)(B) and the text of the regulations precluded the IRS from adjusting the DSUE amount of the predeceased spouse for gifts made before 2010.

Finally, the estate argued that the application of Section 2010(c)(5)(B) by the IRS in this case was contrary to the intent of Congress to permit portability and was "unconstitutional for lack of due process" because it overrode the statute of limitations on assessment established in Section 6501.

The court rejected each of these arguments. It stated the IRS properly exercised the powers inferred by Sections 2010(c)(5)(B) and 7602(a)(1). It examined the return filed by the estate of the predeceased spouse. It found that the DSUE amount had been overstated. It adjusted the amount of the DSUE amount as authorized by the code and the regulations but did not determine an estate tax deficiency for Husband's estate. The Court rejected the two arguments made by Wife's estate that the initial estate tax closing document should bar the IRS' examination of Husband's estate tax return to determine the DSUE amount available to Wife's estate. The court found that the document was not a closing agreement under Section 7121 because there was no negotiation between the IRS and Husband's estate. It also held that the doctrine of equitable estoppel could not be asserted in this situation since the four essential elements were lacking. These four elements are:

1. A false representation or wrongful misleading silence;
2. An error in a statement of fact and not an opinion or a statement of law;
3. The person claiming the benefits of estoppel must be ignorant of true facts; and
4. The person must be adversely affected by the acts and statements of the person against whom an estoppel is claimed.

The court also found that this was not in an improper second examination. It noted that the estate had not cited Section 7605(b) which protects taxpayers from an impermissible second examination. Moreover, even if this was an improper second examination, the IRS would not have violated Section 7605(b) as to Wife's estate. Only the examined party is protected from second examinations.

The court then rejected the estate's argument that the IRS could not adjust the DSUE on the basis of gifts given before December 31, 2010 because the effective date of portability was January 1, 2011. It also rejected the estate's argument that the actions of the IRS violated Congress' intent with respect to portability and was an unconstitutional violation of due process because it overrode the statute of limitations on assessments established in Section 6501. It stated that Section 2010(c)(5)(B) does not give the IRS the power to assess any tax against the estate of the predeceased spouse outside of the period of limitations. However, the IRS "may examine returns of each of the surviving spouse's deceased spouses whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount, regardless of whether the period of limitations on assessment has expired for any such return." The court concluded that the IRS acted within its legal authority when it examined Husband's estate tax return and adjusted the DSUE eligibility to be claimed by Wife's estate. Wife's estate also had to include the lifetime taxable gifts in her estate for the purposes of determining the amount of the estate tax due.

GENERATION-SKIPPING TRANSFER TAX

52. Letter Ruling 201711001 (Issued November 10, 2016; Released March 17, 2017)

IRS grants extension of time to allocate GST Exemption to irrevocable trust

Decedent created an irrevocable trust prior to December 31, 2000. The trust was for the benefit of three children and their families. The trust was a GST trust. CPA prepared the gift and tax returns for the decedent and decedent's spouse, reporting the transfer to the trust and treating the gifts as made one half by each of decedent and spouse. Decedent subsequently died. Subsequently, it was discovered that no GST allocation had been made with respect to the transfer.

The IRS granted an extension of time pursuant to the provisions of Treas. Reg. §§ 301. 9100-1 and 301.9100-3. Under these regulations, requests for an extension of time will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. Treas. Reg. § 301.9100-3 also provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

53. Letter Ruling 201717001 (Issued January 4, 2017; Released April 28, 2017)

IRS grants an extension of time to make a QTIP election with respect to GST Exempt Marital Trust and to make a reverse QTIP election with respect to GST Exempt Marital Trust

This letter ruling involves a typical A/B estate plan. Upon the first spouse's death, the residue of the first spouse's estate passed to a trust which was to be divided into a family trust and a trust for the benefit of the surviving spouse. In turn, the trust for the benefit of the surviving spouse was to be divided into a GST Exempt Marital Trust and a GST Non-Exempt Marital Trust pursuant to a formula. The GST Exempt Marital Trust was to hold the portion of the residue based on the amount of any of the GST exemption available to the decedent's estate and the GST Non-Exempt Marital Trust was to hold the balance of the residue. The GST Exempt Marital Trust was funded but there was insufficient property to fund the GST Non-Exempt Trust.

The co-executors of decedent's estate engaged an accountant to prepare the Form 706. The accountant consulted with an attorney who advised the accountant to make both a QTIP election for estate tax purposes and a reverse QTIP election for GST tax purposes with respect to the GST Exempt Marital Trust. In completing Schedule M on the Form 706, the accountant mistakenly did not include the GST Exempt Marital Trust property as property subject to a QTIP election and therefore, no QTIP or reverse QTIP election was made with respect to the GST Exempt Marital Trust.

Upon discovering the mistake, the estate requested an extension of time to make a QTIP election to treat the GST Exempt Marital Trust as a QTIP Marital Deduction Trust and to make a reverse QTIP election for the trust.

The Service applied the provisions of Treas. Reg. §§ 301.9100-1 and 301.9100-3. Treas. Reg. § 301.9100-3 provides that extensions of time will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. The IRS found that these requirements had been met.

54. Letter Ruling 201718026 (Issued December 20, 2016; Released May 5, 2017)

IRS grants extension of time to allow donors to allocate GST Exemption to Irrevocable Trust

Husband created an irrevocable trust after September 25, 1985 but before October 22, 1986, the date on which the new generation-skipping tax was enacted. As a result, while the trust was not grandfathered, the GST tax had not been enacted when the trust was funded. An attorney prepared and filed the gift tax returns for both Husband and Wife since Wife agreed to split the

gift with Husband. The applicability of the generation-skipping tax to the trust and the failure to allocate GST exemption to the initial transfer made into this trust was discovered years later, Husband and Wife had allocated some of their GST exemption to the trust in subsequent transfers.

Husband and Wife requested an extension of time to make an election under Section 2642(g) pursuant to Treas. Reg. §§ 301.9100-1 and 301.9100-3 to allocate GST exemption to their transfers to the trust effective as of the date of the initial funding of the trust.

Based on the facts submitted, the Service concluded that the requirements of Treas. Reg. § 301.9100-3 had been satisfied. Relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting the relief would not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make the election. Here, because the trust was created and funded after September 25, 1985 but before the enactment of the generation-skipping tax, there was reasonable cause for the donor not realizing that GST tax applied to the trust.

55. Letter Rulings 201725004, 201725005, 201725006, and 201725007 (Issued January 3, 2017; Released June 23, 2017)

IRS provides extension of time to allocate GST exemption to trust

Settlor created and funded an irrevocable trust for the benefit of Son and Settlor's descendants prior to December 31, 2000. Settlor failed to timely file the gift tax return to report the transfer because Settlor relied on tax professionals to advise and prepare the necessary returns. The failure to allocate Settlor's GST exemption was discovered by a law firm when reviewing the GST status of the trust. A gift tax return was then filed by Settlor and an election was made to split the gift with the Settlor's spouse. No additions, either constructive or actual, were made to the trust after the initial transfers and the Settlor had sufficient GST exemption to allocate to the initial transfer. The Settlor requested an extension of time to allocate the GST exemption to the initial transfer.

The Service applied Treas. Reg. § 301.9100-3. Treas. Reg. § 301.9100-3 provides that an extension of time or other relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. In addition, a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional to make the election.

The Service concluded in this situation the requirements of Treas. Reg. § 301.9100-3 had been satisfied and an extension of time to allocate the GST exemption was granted.

56. Letter Rulings 201724022 and 201724023 (Issued March 6, 2017; Released June 16, 2017)

IRS permits extension of time to allocate GST exemption

Donor created an irrevocable trust that might be subject to GST tax and transferred property to the trust. Accountant prepared and filed the Form 709 reporting the transfer of the trust. However, the accountant reported the gift as a direct gift on the gift tax return, improperly reported an allocation of Donor's GST exemption on the incorrect line on Part II of the gift tax return, and failed to attach a notice of allocation. These errors were discovered subsequently when Donor retained new estate planning counsel.

In a ruling request, Donor requested an extension of time to allocate GST exemption to the initial transfer to the trust effective as of the date of the transfer to the trust. Treas. Reg. § 301.9100-3 provides that requests for an extension of time of the relief will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief would not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make an election. Notice 2001-50, 2001-2 C.B. 189 provides that the time for allocating the GST exemption to lifetime transfers and transfers at death, the time for electing out of the automatic allocation rules, and the time for electing to treat any trust as a GST trust are to be treated as if not especially prescribed by statute. The notice further provides a taxpayer may seek an extension of time to make a GST election or elect out of the automatic allocation rules through Treas. Reg. § 301.9100-1 through 301.9100-3.

Here, the Service found that the requirements of the regulation were meet and an extension of time was granted.

57. Letter Ruling 201724008 (Issued March 2, 2017; Released June 16, 2017)

IRS grants extension of time to allocate GST exemption to irrevocable trust

Donor created an irrevocable trust for the primary benefit of his children. Donor hired a law firm to prepare the Form 709–Gift Tax Return. The return did not allocate GST exemption to the transfer to the irrevocable trust.

The Donor requested an extension of time pursuant to Treas. Reg. § 301.9100-3. This regulation provides that a request for an extension of time will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional to make or advise the taxpayer to make the election.

The Service found that the requirements of Treas. Reg. § 301.9100-3 had been met and the extension of time to allocate GSP exemption was granted.

58. Letter Ruling 201724015 (Issued March 9, 2017; Released June 16, 2017)

IRS grants extension of time to elect out of the deemed allocation of GST exemption

Taxpayer created a trust that had the potential of being subject to GST tax. Taxpayer retained a tax professional to prepare the Form 709–Gift Tax Return. Six months later, the tax professional prepared an amended Form 709 to include certain outright gifts (having no GST tax potential) made that year. On the returns, the tax professional failed to elect out of the automatic allocation rules under Section 2632.

The taxpayer requested an extension of time to elect out of the deemed allocation of GST exemption for the gift made to the trust. Treas. Reg. § 301.9100-3 provides that requests for relief such as an extension of time to make an election will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that the requested relief will not prejudice the interests of the Government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional to make or advise the taxpayer to make the election.

The Service found that the requirements of the regulation were met and an extension of time to elect out of the deemed allocation GST exemption was permitted.

59. Letter Ruling 201729018 (Issued March 27, 2017; Released July 21, 2017)

IRS permits an extension of time to opt out of the automatic allocation of GST exemption rules

Decedent established three irrevocable trusts for the primary benefit of each of three children. Decedent retained a law firm to prepare the trusts, establish the trusts and provide advice to the trusts and to prepare any necessary tax returns. The law firm failed to advise the Decedent about the rules regarding the automatic allocation of GST exemption and the ability to elect out of the automatic allocation of GST exemption. The law firm, in preparing the gift tax returns, reported the transfers by the Decedent to each of the three trusts. However, the law firm failed to opt out of the automatic allocation of GST exemption for the transfers to each of the three trusts. At the time of those transfers, Decedent did not intend for GST exemption to be allocated to the trusts which were established primarily to benefit the children of Decedent.

Decedent's estate requested an extension of time to elect out of the automatic allocation rules. Section 2642(g)(1)(A) provides that the Secretary of the Treasury shall prescribe those circumstances and procedures under which extension of time will be granted to make an

allocation of GST exemption or to elect out of GST exemption. Notice 2001-50, 2001-2 C.B. 189, provides that the time for allocating the GST exemption to lifetime transfers and transfers at death, the time for electing out of the automatic allocation rules, and the time for electing to treat any trust as a generation-skipping transfer trust are to be treated as if not expressly prescribed by statute. As a result, taxpayers may seek an extension of time to make an allocation of GST exemption or to elect out of the automatic allocation of GST exemption.

Treas. Reg. § 301.9100-3 provides that requests for an extension of time will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that the grant of the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

The IRS found that the requirements of Treas. Reg. § 301.9100-3 had been met in this situation.

60. Letter Ruling 201736017 (Issued June 1, 2017; Released September 8, 2017)

IRS permits an extension of time to elect out of the automatic allocation rules with respect to GST tax

Grantor and grantor's spouse established an inter vivos irrevocable trust for the benefit of their three children. Each of the trusts had the potential for the imposition of GST tax. An accounting firm discussed and advised the grantor of the automatic allocation of GST exemption rules and the ability to elect out. The accounting firm prepared the gift tax returns that included an election out of the automatic allocation rules for the current gifts and all future gifts to the trust. As a result of errors by the accounting firm, however, the gift tax return was not timely filed. Consequently, the grantor failed to elect out of the automatic allocation rules for the gifts to the trusts.

Grantor requested an extension of time to elect out of the automatic allocation rules The IRS granted the request for an extension of time to elect out of the automatic allocation rules. It found that the requirements of Treas. Reg. § 301.9100-3 were met. Under this Treasury Regulation, a request for relief will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

61. Letter Ruling 201737006 (Issued June 12, 2017; Released September 15, 2017)

Extension of time to opt out of automatic allocation rules for GST exemption permitted

Taxpayer created an irrevocable family trust after December 31, 2000 that had the potential to be subject to GST tax. On the same date, taxpayer established a grantor retained annuity trust. Under the terms of the grantor retained annuity trust, taxpayer's retained interest terminated and any remaining principal passed to the family trust at the end of the second year. For GST tax purposes, the estate tax inclusion period for the grantor retained annuity trust closed on the date of the termination of the grantor's annuity interest. The taxpayer did not intend for the family trust to benefit the grandchildren and did not intend to allocate as GST exemption to the transfers to the GRAT and family trust.

The taxpayer engaged an accounting firm to prepare all the federal and state tax filings. The accounting firm inadvertently reported the transfers to the GRAT and family trust on Schedule A, Part 1 of the gift tax return (gifts subject only to gift tax) instead of Schedule A, Part 3 (indirect skips). In addition, the accounting firm failed to advise the taxpayer of the opportunity to elect out of the automatic allocation rules for the GST exemption. The taxpayer requested an extension of time to opt out of the automatic allocation rules. The Service held that Treas. Reg. § 301.9100-3 would apply. Under this regulation, a request for relief will be granted when the taxpayer provides evidence that the taxpayer acted reasonable and in good faith and that the grant of the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a tax professional.

62. Letter Ruling 201737007 (Issued June 1, 2017; Released September 15, 2017)

IRS permits taxpayer to opt out of automatic allocation GST exemption

Grantor and grantor's spouse establish an inter vivos irrevocable trust for the benefit of each of their three children. Each trust had the potential for GST tax. An accounting firm discussed and advised the grantor about the rules regarding the automatic allocation of GST exemption and the ability to elect out of those rules. The accounting firm prepared a gift tax return that included an election out of the automatic allocation of GST exemption. However, the accounting firm failed to file the gift tax return on time and therefore the opt-out of the automatic allocation failed.

The grantor requested an extension of time to elect out of the automatic allocation rules. The Service granted the request, citing Treas. Reg. § 301.9100-3. That regulation provides that requests for relief will be granted if the taxpayer shows that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional.

63. Letter Rulings 201731005 and 201731010 (Issued April 3, 2017; Released August 4, 2017)

Taxpayer found to have complied with the essential requirements necessary to allocate GST exemption to irrevocable trust

These two letter rulings have the same facts. Husband created an irrevocable trust for the benefit of his descendants. Husband and Wife hired an attorney to prepare the gift tax returns. On each return, Husband and Wife signed their consent to treat the transfers as having been made one half by each spouse under Section 2513. Husband elected out of the automatic allocation rules with respect to the gift to the trust that year. The attorney preparing the gift tax return for Husband correctly reported the transfer to the trust as an indirect gift. The attorney also allocated GST exemption to the transfer on Schedule B, Part 2, line 6; however the attorney failed to attach a Notice of Allocation for this transfer. Because Husband elected out of the automatic allocation rules, Husband could still allocate GST Exemption by properly reporting the allocation on a timely filed gift tax return which Husband did. Husband failed to attach a Notice of Allocation of GST Exemption in accordance with the instructions for Form 709. As a result, Husband failed to literally comply with the instructions for the gift tax return or with the requirements and the regulations for allocating GST exemption to an indirect skip in accordance with Section 2632(c).

The ruling noted that literal compliance with the procedural instructions to make an election is not always required. Elections may be treated as effective where the taxpayer complied with the essential requirements of the regulations (or the instructions to the applicable form) even though the taxpayer failed to comply with certain procedural directions therein. Hewlett Packard Company v. Commissioner, 67 T.C. 736 (1977). As a result, the Service ruled that the gift tax return submitted by Husband contained sufficient information to constitute substantial compliance with the requirements of Section 2632(c) to allocate GST exemption to an indirect skip and, therefore, Husband allocated GST exemption to the transfer to the trust.

64. Letter Ruling 201634016 (Issued May 17, 2016; Released August 19, 2016); Letter Ruling 201634017 (Issued May 17, 2016; Released August 19, 2016)

Modifications of pre-September 25, 1985 grandfathered trusts will not cause trusts to lose their GST exemption

Each of these letter rulings deals with pre-September 25, 1985 irrevocable trusts that were grandfathered from the generation-skipping tax. Each trust was for the benefit of Taxpayer and Taxpayer's issue. The initial trustees were two unrelated individuals and Taxpayer's mother. The provisions of the trusts provided that if any trustee failed or ceased to act, the creator of the trusts, otherwise D would appoint a successor trustee. If neither the creator of the trusts nor D was then living, Bank was to become trustee. No successor trustee was to be appointed to act in the place of the next individual trustee who failed or ceased to act. The last remaining individual trustee could appoint a trustee to act in his or her place and also revoke that appointment. If no

individual trustee was able and willing to act, Bank could appoint an individual as co-trustee. If there was no trustee willing and able to act, the beneficiaries could appoint a trustee.

Taxpayer was given a broad limited testamentary power of appointment. One independent trustee resigned and the creator of the trust appointed the taxpayer as the successor co-trustee to serve with the second independent trustee and the taxpayer's mother. Subsequently, Bank declined to serve as successor trustee and the second independent individual resigned as co-trustee. As a result, as long as Taxpayer and his mother continue to serve, no additional co-trustee will be appointed to serve with them and no successor trustee can be appointed for or by Taxpayer or his mother.

Taxpayer sought a court approved modification of the trusts with respect to the appointment of trustees and distributions of income and principal but did not want to ungrandfather the trusts. Future trustees would be limited to persons who were not related or subordinate under Section 672(c) and the taxpayer could only make distribution to himself pursuant to an ascertainable standard. The Service first ruled that neither the changes in the succession for trustees or in the distribution standards would cause the beneficial interests to be shifted to a beneficiary who occupied a generation lower than the beneficiaries that held the interest prior to the termination or extend the time for the vesting of any beneficial interest beyond the period provided for in the original trust agreement. Consequently, the trusts would not be ungrandfathered and would remain exempt.

In addition, the ability of Taxpayer, if and when serving as trustee of the trust, to make distributions to or for the benefit of Taxpayer was limited by an ascertainable standard. Finally, although Taxpayer could remove and replace a trustee or co-trustee, any trustee or co-trustee appointed by Taxpayer could not be related or subordinate within the meaning of Section 672(c). As a result, Taxpayer would not be considered to have a taxable general power of appointment for either estate tax or gift tax purposes.

65. Letter Ruling 201633023 (Issued April 20, 2016; Released August 12, 2016)

Proposed modifications of grandfathered GST Trust will not subject trust to GST tax

Grandfather created an irrevocable trust for the benefit of his grandchildren prior to September 25, 1985. The trust was immediately divided into separate equal trusts for each child of grandfather. Each child's trust was to be held undivided during periods when that child had no living issue. When a grandchild was born, the trustees were to create a share for the account of the grandchild. The trust provided for discretionary distributions of income and principal. At age 25, the grandchild had the right to withdraw one-half of the value of the trust. The trust would terminate when the grandchild reached age 35. The grandchild was given a testamentary power of appointment to spouses, grandfather's issue other than the grandchild, or the spouses of such issue to be appointed by will after the grandchild attained the age of 18.

One grandchild was born with cognitive deficits and disabilities. The trustees petitioned to modify the terms of that grandchild's trust so that the trust would terminate upon the death of that grandchild. It was represented that modification to keep the grandchild's inheritance in trust for a lifetime furthered the purpose of the trust to provide financially for the grandchildren of grandfather.

The proposed modification provided that if the grandchild died before the age of 25, the property would pass in the same manner as under the terms of the original trust. If the beneficiary died between the ages of 25 and 35, one-half of the remaining property of the trust was includable in the grandchild's gross estate. If the grandchild died after the age of 35, the entire trust would be includable in beneficiary's gross estate.

Based on the facts presented, the Service ruled that the trust for the one grandchild would remain exempt from the application of the GST tax and no distributions would be subject to GST tax.

66. Letter Rulings 201642027–201642030 (Issued June 22, 2016; Released October 14, 2016)

Modification of grandfathered GST Trusts will have no adverse tax consequences

Prior to September 25, 1985, husband and wife created five irrevocable trusts for different beneficiaries. Trusts One, Two, Three and Five were created for the primary benefit of separate grandchildren. Trust Four was created for the primary benefit of Daughter.

Grandchild Four, the beneficiary of Trust Five, died without issue. Pursuant to the terms of Trust Five, the assets of the trust were distributed evenly among each of Trust One, Trust Two, Trust Three, and Trust Four. Daughter petitioned the state court to modify Trust Four to request the appointment of a corporate trustee to replace the six individual trustees then serving. After extended negotiations, the grandchildren, Daughter, and the six individual trustees entered into a settlement agreement which the state court approved. The settlement agreement provided that a corporate trustee would be appointed to serve as the sole corporate trustee of Trust Four. It also provided that Trust One, Trust Two, and Trust Three would be divided into two resulting trusts with the corporate trustee serving as the sole corporate trustee of one successor trust and individuals serving as trustees of the other successor trust.

The settlement agreement also provided that the trustee removal and appointment provisions of the trust would be modified to provide that the distributees, with court approval, could remove any corporate trustee and replace that trustee with another corporate trustee.

The IRS ruled that the proposed modifications of each trust did not cause any adverse GST consequences. No beneficial interest would be shifted to a beneficiary occupying a lower generation and the modifications to provide for a change in trustee and to modify this successor trustee procedures were administrative in nature and could not be considered to shift a beneficial interest to a lower generation or extend the time for the vesting of any beneficial interest in the trust beyond the original perpetuities period. None of the powers granted to any beneficiaries

would be considered a taxable general power of appointment since the powers of the trustees were limited to ascertainable standards.

The IRS also ruled that the division of the trusts for the grandchildren into two separate successor trusts would have no adverse income tax effects. The IRS finally ruled that the reimbursement of the payment of attorneys' fees by any beneficiary would not result in adverse income tax treatment to the beneficiary, but would be deductible under Section 2012 of the Internal Revenue Code.

67. Letter Ruling 201702016, Letter Ruling 201702017 and Letter Ruling 20170218 (Issued September 19, 2016; Released January 13, 2017)

Proposed modification of trust will not result in adverse GST consequences

An irrevocable trust was created prior to September 25, 1985 and was grandfathered for GST tax purposes. Subsequently, three separate trusts were established with identical terms, one trust for each of the settlor's three sons. Each separate trust provided that the trustees could distribute the net income among the son and his issue at the trustee's discretion. The trustees also had the discretion to distribute principal for the son or his issue pursuant to an ascertainable standard. If the son was living at the death of the survivor of the settlor and settlor's spouse, the trustees were directed to distribute 1/10th of the principal to the son when the son reached age 30, 4/9ths when the son reached age 35 and 4/9ths when the son reached the age 40. Upon the death of the son, the son was given a limited power of appointment. Otherwise, the trust was distributed to the son's issue per stirpes.

Under the applicable state law, the beneficiaries and the trustee proposed to enter into a non-judicial settlement to amend certain administrative provisions of the trust, to add a new provision that at least one independent trustee was to serve each separate trust, and to provide that each individual trustees, by a majority vote could appoint individuals to serve as additional trustees otherwise, the son, otherwise the beneficiaries.

Three rulings were requested:

1. The proposed modifications to the trust would not constitute a general power of appointment for estate or gift tax purposes causing the assets of the trust to be includible in son's estate at death and would not be deemed to be transferred by son for gift taxes purposes.

2. The proposed modifications would not constitute a constructive addition to the trust and ungrandfather the trust.

3. The proposed modifications will not cause distributions from the trust or the termination of any interest in the trust to be subject to GST tax.

4. The IRS found that none of the proposed modifications would affect the dispositive provisions of the trust.

As a result, the proposed modifications would not constitute a taxable general power of appointment.

The IRS also ruled that the proposed changes would not shift a beneficial interest to a lower generation in the trust and would not ungrandfather the trust for GST purposes under Section 2601.

68. Letter Ruling 201706002 (Issued October 24, 2016; Released February 10, 2017)

IRS finds that changes to grandfathered GST trust will not result in adverse GST tax consequences

Settlor established an irrevocable trust for the benefit of son and son's family prior to September 25, 1985. The trust was grandfathered from GST Tax. The son had three children: Child A, Child B, and Child C. The trustees of the trust filed a petition to divide the trust into three separate trusts, one for the benefit of the family line of each of the son's children. Each divided trust was to be funded with 1/3rd of the assets of the trust on a pro rata basis.

Each divided trust was to have the same terms as the original trust. There would be a separate trust for the benefit of the son and the son's spouse; the son's child (that is, Child A, Child B, or Child C); the child's issue; the child's spouse; and the issue of the child's spouse. The trust requested a ruling that the proposed division and modification of the trust would not cause either the original trust or the divided trusts to lose their GST tax exempt status and would not cause any distribution from or termination of any interest in the original trust or the divided trusts to be subject to GST tax.

The Service concluded that the proposed division and modification of the original trust would not shift a beneficial interest in the original trust to any beneficiary who occupied a lower generation than the persons holding the beneficial interests prior to the division and modification. In addition, the proposed division and modification would not extend the time for vesting of any beneficial interest in the divided trust beyond the period provided in the original terms of the original trust. Accordingly, the proposed division and modification would not cause the original trust or any of the divided trusts to lose their exempt status and would not cause any distribution from or termination of any interest in the original trust or the divided trust to be subject to GST tax. This was pursuant to Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1) that provides that a modification of the governing instrument of an exempt trust by judicial reformation or non-judicial reformation that is valid under applicable state law will not cause an exempt trust to be subject to GST tax, if (1) the modification does not shift a beneficial interest in the trust to a beneficiary in a lower generation than the person or persons who held the beneficial interest prior to the modification and (2) the modification does not extend the time for vesting of any beneficial interest of the trust beyond the period provided for in the original trust.

69. Letter Ruling 201702016, Letter Ruling 201702017 and Letter Ruling 20170218 (Issued September 19, 2016; Released January 13, 2017)

Proposed modification of trust will not result in adverse GST consequences

An irrevocable trust was created prior to September 25, 1985 and was grandfathered for GST tax purposes. Subsequently, three separate trusts were established with identical terms, one trust for each of the settlor's three sons. Each separate trust provided that the trustees could distribute the net income among the son and his issue at the trustee's discretion. The trustees also had the discretion to distribute principal for the son or his issue pursuant to an ascertainable standard. If the son was living at the death of the survivor of the settlor and settlor's spouse, the trustees were directed to distribute 1/10th of the principal to the son when the son reached age 30, and 4/9ths when the son reached age 35. Upon the death of the son, the son was given a limited power of appointment. Otherwise, the trust was distributed to the son's issue, per stirpes.

Under the applicable state law, the beneficiaries and the trustee proposed to enter into a non-judicial settlement to amend certain administrative provisions of the trust, to add a new provision that at least one independent trustee was to serve each separate trust, and to provide that each individual trustees, by a majority vote could appoint individuals to serve as additional trustees otherwise, the son, otherwise the beneficiaries.

Three rulings were requested:

1. The proposed modifications to the trust would not constitute a general power of appointment for estate or gift tax purposes causing the assets of the trust to be includible in son's estate at death and would not be deemed to be transferred by son for gift taxes purposes.

2. The proposed modifications would not constitute a constructive addition to the trust and ungrandfather the trust.

3. The proposed modifications will not cause distributions from the trust or the termination of any interest in the trust to be subject to GST tax.

4. The IRS found that none of the proposed modifications would affect the dispositive provisions of the trust.

As a result, the proposed modifications would not constitute a taxable general power of appointment.

The IRS also ruled that the proposed changes would not shift a beneficial interest to a lower generation in the trust and would not ungrandfather the trust for GST purposes under Section 2601.

70. Letter Ruling 201711002 (Issued November 30, 2016; Released March 17, 2017)

Merger of GST exempt trusts will not affect exempt status

Settlor established an irrevocable trust for the benefit of her granddaughter, granddaughter's spouse, and granddaughter's children and future issue. The trust was created before September 25, 1985 and was therefore grandfathered.

The trust provided that when the second of the granddaughter and the spouse died, the trust was to be divided into equal shares for the granddaughter's children that are living on the death of the last survivor. After spouse's death, the trust was divided into three separate trusts. One trust was to benefit granddaughter and her issue (Trust A1), one trust was to benefit granddaughter's great grandchild one and that great grandchild's issue (Trust A2) and one trust to benefit granddaughter's great grandchild two and great grandchild two's issue (Trust A3). After granddaughter died, pursuant to a court order, Trust A2 was divided into six separate trusts. This letter ruling related to the three trusts established after granddaughter's death.

In addition, a similar trust to Trust A was established by the settlor, called Trust B. These trusts contained the same provisions and termination dates as the trust created under Trust A. Because similar trusts were created under Trust A and Trust B for the different groups of descendants, it was proposed to merge each of those trusts.

The Service ruled that because the terms of the trusts were the same and would not extend the time for vesting any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership, the power of alienation of interest property that the merger would not have any adverse GST results.

71. Letter Ruling 201718014 (Issued January 25, 2016; Released March 5, 2017)

Transfer of assets from one trust to a successor trust followed by modifications to the successor trust will not result in the loss of the trust's GST exemption

Grantor established four separate irrevocable trusts, one for the benefit of each of his four children, prior to September 25, 1985. Consequently, each trust was exempt from generation-skipping tax. This letter ruling related to Trust 1 of which the Daughter and a Bank were the current trustees. The Daughter, Son 1, Son 2, and two of Son 2's minor children were the current beneficiaries of Trust 1. No additions were made to the Trust 1 after September 25, 1985.

The Bank planned to resign as trustee of Trust 1. Upon receipt of a favorable letter ruling, the trustees planned to appoint the assets of Trust 1 to Trust 2. Trust 2 will be governed by the laws of a new state. Trust 2 will have the same beneficiaries and will not extend the time for vesting of any beneficial interest in the trust assets beyond the period provided in Trust 1 and will contain the same distribution and dispositive provisions of Trust 1. Trust 2 authorizes only a Disinterested Trustee to make distributions from the trust to beneficiaries. Trust 2 will also modify the provision governing trustee resignation and the removal and appointment of individual and corporate trustees.

The trustee will also add provisions to Trust 2 concerning the appointment and service of a trust protector of the Trust 2.

The Service found that the transaction satisfied the requirements of Treas. Reg. § 26.2601-1(b)(4)(i)(D). The distributions from Trust 1 to Trust 2 would not shift the beneficial interests to a trust beneficiary who occupied a lower generation than the current beneficiaries. The distribution also cannot extend the time for vesting any beneficial interest in the trust beyond the period provided for in the original Trust. As a result, the transfer of assets will not cause the Trust to lose GST exempt status. In addition, because the changes in the successor trustee provisions and the addition of the trust protector provisions were administrative in nature and they would not be considered a shift of the beneficial interests to lower generations in the trust.

As a result, the proposed transfer to a new trust, the modification of the successor trustee provisions, and the addition of trust protector provisions would not cause the trust to lose its GST Exempt status.

72. Letter Ruling 201724007 (Issued March 2, 2017; Released June 16, 2017)

Service rules on gift splitting in allocation of GST exemption to irrevocable trust

Wife created a trust for the benefit of her spouse and their descendants. In year one, Wife transferred property to the trust. Also in that year, Husband transferred property outright to three adult children.

During Husband's life, the trustee of the irrevocable trust has the discretion to distribute income and principal to Husband for his comfort, welfare, and best interests. If Wife pre-deceased Husband, the trustee had the discretion to distribute income and principal to Husband and his descendants for their comfort, welfare and best interests. Upon the death of the Husband, the remaining principal was to be divided and held in separate trusts for the benefit of the Settlor's surviving children and the issue of deceased children.

Husband and Wife each timely filed a gift tax return for the year. On each gift tax return Husband and Wife signified their consent to treat all of the gifts in that year as split gifts. On each of Husband and Wife's gift tax returns, the property transferred to the trust was mistakenly reported on Schedule A, Part 1 (gifts subject to only to gift tax). Wife did not report any allocation of GST exemption to the transfer to the trust on Schedule D, Part 2. Additionally, Wife did not attach a statement electing out of the automatic allocation of GST exemption to the Form 709. Husband's form was similar.

Subsequently, Wife and Husband amended their Forms 709 to correctly report the transfers to the trust on Part 3 (indirect skips) of Schedule A and to change Schedule D, Part 2, Line 5 to indicate that their respective GST exemptions were automatically allocated to the transfer to the trust. The amended return was filed pursuant to Revenue Procedure 2000-34, 2000-34 I.R.B. 186.

Husband and Wife each elected split gift treatment for these gifts. The Service found that under Section 2504(c), the time for determining whether gift splitting treatment is effective with respect to the initial transfer with respect to the first year had expired. Therefore the split gift

treatment was irrevocable for purposes of that transfer and it applied to all gifts made during the year by both spouses as reported on the returns.

The Service also held that the trust was a GST trust for purposes of the automatic allocation rules. Husband and Wife had each timely filed a Form 709 for year one signifying their consent to treat the year one gifts to the trusts as having been made one-half by each spouse. Husband and Wife were bound by their consent. Subsequently Husband and Wife filed the amended Form 709 to report the transfer as an indirect skip and report that their GST exemptions were automatically allocated to the transfer. As a result, each of Husband and Wife would be treated as the transferor of one-half of the value of the entire value of the property transferred to the trust in year one and the automatic allocation rules would apply to allocate Husband and Wife's GST exemptions to one-half of the year one transfer to the trust.

73. Letter Ruling 201704005 (Issued October 3, 2016; Released January 27, 2017)

IRS grants extension of time to sever marital trust into exempt and nonexempt trusts and make a reverse QTIP election

The first spouse to die provided for an estate plan under which a pecuniary amount was to fund the marital trust. In addition, the marital trust was to be divided into an exempt marital election trust and a non-exempt marital trust. The marital election trust was intended to receive the first spouse's GST exemption. The non-exempt amount was to fund the non-exempt marital trust. Upon the surviving spouse's death, the two marital trusts passed to a residuary trust. In turn, 50 percent of the assets of the residuary trust was to fund a charitable lead unitrust (CLUT) and the remaining 50 percent was to fund trusts for the decedent's three children. The charitable lead unitrust was to pay a unitrust amount to charity for 25 years. The unitrust amount was to be a percentage of the entire trust that would produce a remainder interest to the first spouse's children equal in value to the amount of the GST exemption available to the first spouse upon his or her death.

An attorney prepared the estate tax return for the first spouse's estate. However, the attorney failed to divide the marital trust into the marital election trust and the non-exempt trust. In preparing the federal estate tax return for the first spouse's estate, the attorney also failed to make a QTIP election with respect to the assets passing to the marital trust and to allocate first spouse's unused GST exemption to the marital election trust. The attorney listed the CLUT instead of the marital election trust and failed to make a reverse QTIP election for GST purposes for the marital election trust.

The attorney's failure to divide the marital trust into the marital election trust and the non-exempt marital trust and to make a reverse QTIP election for the marital election trust was discovered after the surviving spouse's death. As a result, the current trustees petitioned the local court to correct the mistakes. The local court ordered that the marital trust was to be divided into the marital election trust and the non-exempt marital trust. The CLUT was to be funded from the assets of the marital election trust and then from the assets of the non-exempt

marital trust so that the total assets in the CLUT would equal one-half of the combined assets of the marital election trust and the non-exempt marital trust. The local court further ordered that the personal representative of the surviving spouse's estate could allocate the surviving spouse's available GST exemption to the CLUT.

The IRS permitted an extension of time of 120 days to sever the marital trust and the marital election trust and the non-exempt marital trust and to make a reverse QTIP election with respect to the marital election trust. In addition, the automatic allocation rules of Section 2632 would apply to automatically allocate the first spouse's unused GST exemption to the marital election trust. Upon division of the CLUT into two charitable lead unitrusts, the charitable interest of each charitable lead unitrust would qualify as a charitable lead interest for purposes of Section 2055. Finally, upon division of the CLUT into two charitable lead unitrusts, the charitable lead unitrust funded from the marital election trust would be treated as if the first spouse was the transferor for GST purposes.

74. Letter Ruling 201731006 (Issued April 10, 2017; Released August 4, 2017)

Extension of time granted to sever QTIP Marital Deduction into exempt trust and non-exempt trusts, to make a reverse QTIP election with respect to the exempt trust, and to apply the automatic allocation rules to allocate decedent's GST exemption to the exempt trust

Decedent created a QTIP marital deduction trust for the benefit of the surviving spouse. Decedent's executor hired a law firm to represent the estate in the administration. The executor relied on the law firm to prepare and timely file the federal estate tax return. On the filed federal estate tax return, the executor reported the marital trust as a QTIP trust. Consequently, the executor was deemed to have made a QTIP election for estate tax purposes. However, the law firm did not advise the executor to sever the marital trust into exempt and non-exempt trusts or to make a reverse QTIP election to use decedent's GST exemption. Consequently, the marital trust was not severed, no reverse QTIP election was made on the estate tax return, and decedent's GST exemption was not allocated to the exempt marital trust.

Upon the surviving spouse's death, decedent's estate tax return was reviewed and a new attorney advised the executor of the failure to make the reverse QTIP election and to allocate decedent's remaining GST exemption. The executor requested an extension of time to divide the marital trust into exempt and non-exempt trusts, to make the reverse QTIP election for the exempt trust, and to allocate decedent's GST exemption to the exempt trust.

Under Treas. Reg. § 301.9100-3, a request for an extension of time will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief would not prejudice the interests of the government. Based upon the facts submitted, the IRS concluded that the requirements of Treas. Reg. § 301.9100 were satisfied and an extension of time was granted to sever the marital trust into exempt and non-exempt trusts and to make the reverse QTIP election with respect to the exempt trust.

The Service also ruled that the automatic allocation rules of Section 2632 applied to automatically allocate decedent's unused GST exemption to the newly created exempt trust. Treas. Reg. § 26.2632-1(d)(2) provides that decedent's unused GST exemption is allocated first to direct skips. The balance is allocated to the otherwise non-exempt portion of a trust with respect to which a taxable termination may occur or from which a taxable distribution may be made.

75. Letter Rulings 201707003 (Issued October 12, 2016; Released February 17, 2017) and 2017004 (Issued October 12, 2016; Released February 17, 2017)

Declaratory judgment does not cause trust to lose GST exempt status

An irrevocable trust was established for the benefit of Son prior to October 21, 1942 and thus was grandfathered from GST Tax. Son commenced litigation in which he alleged that the trustee had abused the trustee's discretionary authority by withholding income from Son. At that time, Son had four children. Subsequently, all of the necessary parties entered into a settlement agreement which was approved by the Court. Under the settlement agreement, the original trust was partitioned into two separate trusts, Trust A and Trust B. Son released any powers of appointment given to him, Son's wife disclaimed certain powers that she had with respect to Trust B, and Son's daughter (Granddaughter) disclaimed all of her interests in Trust B.

Son subsequently died survived by his spouse, four children, grandchildren, and great-grandchildren. After Son's death, trustee realized that when the various documents, including the trust instrument, the disclaimer of Son's wife, the daughter's disclaimer, the Granddaughter's disclaimer, and the settlement agreement were read together, ambiguities existed regarding the identity of the beneficiaries of Trust B following Son's death, the proper standard for making distributions of income from Trust B, how the remaining assets of Trust B should be distributed upon termination, and how a beneficiary's interest should pass in the event the beneficiary is not living. The trustee filed a declaratory judgment to resolve these ambiguities and a declaratory judgment was issued.

The Service was requested to rule that the declaratory judgment would not cause any adverse estate tax, gift tax, or GST tax issues. The Service in looking at the proposals indicated that the proposed modifications would not cause the trust to lose its GST grandfathered status. In addition, there would be no adverse gift or estate tax issues with respect to the modifications. The Service also ruled that Granddaughter's disclaimer was a qualified disclaimer and the disclaimer would not create a transfer subject to gift tax, would not cause any part of disclaimed interest in Trust B to be included in the Granddaughter's gross estate for federal estate tax purposes, and would not create a transfer subject to GST tax.

76. Letter Rulings 201712003, 201712004, and 201712005 (Issued November 29, 2016; Released March 24, 2017)

Court-ordered modifications will not affect generation-skipping tax exempt status of trusts

In each of these letter rulings, a grantor created an irrevocable trust to benefit his three daughters. Each trust was created prior to September 25, 1985 and was thereby grandfathered from the generation-skipping tax. Each daughter was the primary beneficiary of a trust created for her benefit. In drafting the trust, two errors were made by the drafting lawyer to which that lawyer admitted. First, the trust failed to include a provision directing how assets were to be distributed if the primary beneficiary died without surviving issue. Second, each trust contained no distribution provisions for any share allocated to the issue of a deceased child of the grantor's daughters. When the grantor executed the trust he was not aware that the terms of the trust failed to contain these distribution provisions.

The trustees petitioned the court to modify the terms of the trust to resolve the ambiguities and conform the trust to the grantor's intention as to the distribution of the assets. The court issued an order that modified and restated the trust.

The trustees requested a ruling from the Service that the court ordered modifications of the trust to correct the lawyer's drafting errors and resolve ambiguities related to the administration and distribution of each of the separate trusts for the three daughters would not cause each trust to lose its GST exemption.

The trustees noted that no additions had been made to the trust since September 25, 1985.

Treas. Reg. § 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to generation-skipping tax if the judicial action involved a bona fide issue and the construction is consistent with the applicable state law that would be applied by the highest court of the state.

The letter ruling noted Treas. Reg. § 26.2601-1(b)(4)(i)(E), Example 3, which considered a situation in which a grantor established an irrevocable trust for the benefit of the grantor's two children and their issue. The trust was to terminate on the death of the last to die of the two children with the principal distributed to the issue. However, the provision governing the termination of the trust was ambiguous on whether the distribution was to be made to the descendants of the two children on a per stirpes basis or a per capita basis. The trustees filed a construction suit with the appropriate local court to resolve the ambiguity and the court issued an order construing the instrument to provide for a per capita distribution to the descendants. The example notes that this trust will not be subject to GST tax because it involved a bona fide issue regarding the interpretation of the instrument and was consistent with applicable state law as it would be interpreted by the highest court of the state.

A statute of the state whose law governed the trusts provided that a court may reform the terms of a trust to conform to the trustor's intention if the failure to conform was due to a mistake of fact or law and the intent of the grantor can be established.

The ruling also applied the test in Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). In Bosch, the Supreme Court concluded that a decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rules of state law to be applied in a federal matter. If the highest state court has issued no decision, the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In effect, the federal agency sits as a state court.

In each of these three letter rulings, the IRS found that ambiguities existed in the trust and the judicial action involved bona fide issues. It found that the court-ordered modifications to the trust were consistent with applicable state law that would be applied in the highest court of the state and held that the court-ordered modifications would not cause each of the trusts to lose its GST exempt status.

77. Letter Ruling 201735009, (Issued May 25, 2017; Released September 1, 2017)

Judicial reformation of trust will not subject the trust to GST tax

This letter ruling involved a pre-1985 grandfathered GST irrevocable inter vivos trust that was for the primary benefit of son and son's issue. Pursuant to a power to amend the trust, a trust committee amended the trust several times prior to September 25, 1985. The committee also amended the trust subsequently to September 25, 1985. One change made by one amendment to add an additional relative of the grantor as a beneficiary would arguably extend the term of the trust. Subsequently, the trustees of the trust sought a judicial construction of the effect of the amendment adding the additional relative to specifically find that the addition of the relative as a contingent beneficiary would not add the relative as a measuring life in determining the duration of the trust and under the state common law rule against perpetuities, the amendment was void ab initio and that state law prohibited the use of the additional relative from being a measuring life. The court construed the trust as requested.

The trustee now requested a ruling that the amendment to the trust and the subsequent court construction of the trust did not cause the trust to lose its exemption from GST tax. The IRS noted that the amendment to the trust to add the additional relative as a contingent beneficiary created an ambiguity but that the court issue an order construing the amendment to assent to be sure that the additional relative was not treated as a measuring life for purposes of determining the duration of the trust. As a result, the trust would not be subject to additional GST tax or and would retain its grandfathered status.

78. Letter Ruling 201723002 (Issued January 23, 2017; Released June 9, 2017)

Irrevocable life insurance trust reformed to avoid adverse estate and generation skipping tax consequences

Grantor created an irrevocable life insurance trust with the intention that life insurance policies would be owned by the trust and the proceeds would be available for distribution at the death of the Grantor, the Grantor would pay gift tax during life for her gifts to pay the annual insurance premiums, and no estate tax would be payable at Grantor's death. An attorney drafted the trust agreement and there was a third party trustee. One paragraph of the trust contained a provision that could possibly cause the inclusion of the trust in Grantor's estate under Section 2036. This provision stated that the share for each of Grantor's children and the then living descendants of the deceased child would be determined through a percentage which used the value of property distributed to the child or the child's descendants under Grantor's will as the numerator and the total value of all property distributed to Grantor's children and their descendants under Grantor's will was the denominator. This arguably was a retained Section 2036(a)(2) power in the Grantor to control the use and enjoyment of the property in the irrevocable life insurance trust by others.

Upon discovery of this error, Grantor sought a court reformation to reform or to revise the paragraph to eliminate the possible retained power over the trust. The court granted the petition to reform the trust.

The Grantor then requested rulings from the IRS that (i) Grantor's transfers to the trust would be completed gifts for gift tax purposes, (ii) the assets of the trust would escape inclusion in Grantor's gross estate at her death, and (iii) there would be no adverse GST tax consequences.

The Service granted each of the requested rulings. It found that it had always been the Grantor's intention, shown in declarations made by the Grantor and the drafting attorney to the court, that the trust escape estate taxation. And the court reformation was necessary to correct the scrivener's error to reflect the true intentions of Grantor. The Service also ruled that the reformation would be effective as of the date of the creation of the trust, that Grantor's transfers to trust were completed gifts on the date of such gift, and that the allocation of GST exemption would be based upon the gift tax value of the property transferred as initially transferred.

79. Letter Ruling 201641020 (Issued June 14, 2016; Released October 7, 2016)

IRS discusses consequences of trustee resignation

This letter ruling involves a pre-September 25, 1985 irrevocable GST exempt trust. The trust was amended to provide that a trustee may, in the trustee's absolute discretion, pay such sums of money, whether income or principal, to their daughters.

Husband was trustee of the trust. If Husband ceases to serve as trustee, the daughters will serve as trustees. Upon the death of the first daughter, the surviving daughter will become the sole

trustee and the sole current beneficiary of Trust Two. Daughters were concerned that the surviving daughter may be deemed to have a general power of appointment for gift and estate tax purposes. Daughters proposed to jointly resign as trustees and to petition a court to name two individuals who were not related or subordinate persons within the meaning of Section 672(c) as successor trustees.

The IRS ruled that the joint resignation of the daughters as co-trustees, the appointment of the two unrelated and independent individuals as successor trustees, and the amendment of the trust to provide only for the appointment of successor trustees who are not related or subordinate would not cause either daughter to have a general power of appointment, would not cause the interest of the daughters to be includible in their respective gross estates as a retained power, and would not cause the trust to lose its GST tax-exempt status.

80. Letter Ruling 201732029 (Issued April 20, 2017; Released August 11, 2017)

Reformation of grandfathered GST Trust to correct scrivener's error will have no adverse estate, gift, or generation-skipping tax consequences

Decedent created an irrevocable trust prior to September 25, 1985 and thus the trust was grandfathered from GST tax. Under the terms of the trust, the income and principal of the trust was to be available for the son of the decedent and son's children during the lifetime of son. Upon the death of the son, the assets of the trust would to be divided into separate trusts equal in number to the then surviving children of son until each child reached the age of 30 years at which time one-half of the principal of the trust would be distributed to the child with the balance being distributed to the child at age 35. Son had three children of whom two children were now living and one child was deceased. The deceased child left three children of her own. As a result of a scrivener's error, upon son's death, the children of the predeceased granddaughter would not receive a distribution from the trust. In order to correct the scrivener's error, the trustee petitioned the county court to reform the provisions of the trust by removing the word "surviving" from the paragraph of the trust with respect to distributions to the son's children upon the death of the son.

Three rulings were requested:

- The proposed court reformation could not cause the trust to have any adverse GST tax liability;
- The proposed reformation would not result in any gift tax liability to the beneficiaries; and
- The proposed reformation would not result in any estate tax liability to the beneficiaries.

The IRS held that the court reformation would have no adverse tax consequences. It found that the reformation of the trust was consistent with applicable state law that would be applied in the

highest court of the state. As a result, the proposed reformation would not cause the trust to lose its GST exempt status under Section 2601 or result in any GST tax liability to any beneficiary of the trust. Under Treas. Reg. § 26.2601-1(b)(4)(i)(C), a judicial construction of a governing instrument will not cause an exempt trust to be subject to GST tax if the judicial action involves a bona fide issue and the construction is consistent with applicable state law that would applied by the highest court of the state. Those conditions were met. The IRS also ruled that the proposed court reformation would have no estate or gift tax liability to the beneficiaries.

81. Letter Ruling 201735005, (Issued May 8, 2017; Released September 1, 2017)

Inadvertent payment by trust beneficiary of federal and state income taxes will not have adverse estate, gift, or GST tax consequences

This letter ruling involved a lifetime grandfathered GST irrevocable trust created prior to September 25, 1985. The trust was for the benefit of daughter and her issue. The trust was funded with shares of stock in an S corporation and was a qualified subchapter S trust.

Subsequent to the creation of the trust, the trustee sold the trust's shares of stock in the S corporation in a transaction that resulted in capital gains to the trust for federal and state tax purposes. Pursuant to state law, the capital gains should have been allocated to trust principal and all income taxes due on the capital gains were required to be paid from trust principal. However, the trustee issued a Schedule K-1 to the daughter which treated the capital gains as a taxable distribution to the daughter for both federal and state tax purposes.

After receiving the Schedule K-1 the daughter reported the entire amount of the capital gains on her individual federal and state income tax returns which she jointly filed with a spouse. The errors on the schedule K-1 were in Year 1. The trustee made an additional distribution to daughter in year 2 as a partial reimbursement for the income taxes erroneously paid by daughter and spouse. The daughter did not waive the right of recovery with respect to the erroneous payment of income taxes in Year 1.

The trustee subsequently prepared a draft of its first accounting. Upon receipt of the draft accounting, daughter became aware that she was due an additional reimbursement from the trustee for the income taxes that she and her spouse in connection with the sale of the S corporation stock. The daughter sought a court order to have the trustee reimburse her spouse and her for the income taxes they paid in error.

The daughter also requested a ruling from the IRS that the inadvertent payment by the daughter of the federal and state income taxes would not constitute a constructive addition to the trust for generation skipping tax purposes and that the subsequent reimbursement to the daughter of the income taxes paid together with interest and attorney's fees would not cause any portion of the trust to be subject to GST tax. Rulings were also requested that the inadvertent payments would have no adverse estate and gift tax consequences.

The IRS ruled that there was no constructive addition to the trust for GST purposes that would cause the trust to lose its exemption. It noted that the daughter did not waive her right to recovery and petitioned the court to reimburse her for unreimbursed income taxes with interest and penalty and the Trustee had agreed to reimburse the daughter. Consequently, no addition to the trust occurred as a result of the daughter's inadvertent payment of the income taxes and the trust's prior reimbursement of income taxes and subsequent reimbursement under the court order for the income taxes together with interest and payment.

Also, since there was no change in beneficial interest or the beneficiaries and no transfer of property had occurred as a result of the inadvertent payment of the income tax and the reimbursement of income taxes, daughter did not make a gift to the trust for gift tax purposes.

Finally, since daughter did not transfer any property to the trust, Section 2036 would not apply to cause any property in the trust to be included in daughter's estate at her death since in order for Section 2036 to apply, there must be a transfer.

FIDUCIARY INCOME TAX

82. Green v. United States, 117 A.F.T.R.2d 2016-700 (W.D. Okla. 2016)

Trust can claim an income tax charitable contribution deduction for a cash contribution despite the wrong entity originally making the contribution and having the contribution credited to it

David M. Green, Barbara A. Green, and Mark D. Green created the 1993 Dynasty Trust. The dynasty trust expressly authorized the trustee to distribute such amounts from the gross income of the dynasty trust as the trustee determined to be appropriate. This specifically included distributions to charity. Between 2002 and 2004, Hob-Lob LP owned or operated many, but not all, Hobby Lobby stores. During the same period, the dynasty trust was a 99 percent limited partner in Hob-Lob LP. Hob-Lob LP, when it filed its yearly income tax return with the IRS, issued a Schedule K-1 to each of its partners including the dynasty trust.

In 2004, Hob-Lob LP donated $1,870,204.46 to Reach the Children Foundation. Hob-Lob LP was allowed a 99 percent deduction for its cash payments to Reach the Children Foundation. In 2004, Hobby Lobby donated $4.7 million in cash to Reach the Children Foundation and Book of Hope. The trustee of the dynasty trust stated that, although the contribution of $4.7 million was inadvertently issued by Hobby Lobby, the donation was actually made by Hob-Lob LP and was properly accounted for on Hob-Lob LP's audited 2004 financial statements. The mistake apparently occurred because Hob-Lob LP and Hobby Lobby had a shared accounting system.

In 2005, the dynasty trust filed its Form 1041 for the tax year 2004 claiming a charitable deduction totaling $20,526,383. After the discovery and correction of the inadvertent issuance of the $4.7 million donation by Hobby Lobby to Reach the Children and Book of Hope, the dynasty trust then filed an amended Form 1041 increasing its reported charitable deduction to $29,654,233 and claiming a tax refund of $3,194,748.

The IRS disallowed the refund and moved for summary judgment. The IRS contended that deductions cannot be exchanged or sold or otherwise distributed among taxpayers. The court noted that a charitable contribution was at issue. Although the contribution was originally issued on Hobby Lobby checks, the subject contribution was ultimately borne by Hob-Lob LP. Once discovered, the clerical error was thoroughly addressed. Letters of correction were sent, affidavits were signed, books were corrected, and Hob-Lob LP reimbursed Hobby Lobby's account for the full amount of the contribution. It noted that the dynasty trust was seeking relief in accordance with Hob-Lob's correct financial statements that reflected the actual contributions made by Hob-Lob LP. To disallow a charitable deduction simply because of a clerical error went against the liberal policy of encouraging charitable giving. As a result, the court denied the IRS's motion for summary judgment.

83. CCA 201651013 (Released December 16, 2016)

Trust modified by court order not entitled to claim a charitable income tax deduction under either Section 642(c)(1) or distribution deduction under Section 661

In this advisory, Parent Trust was a GST Exempt trust for the benefit of two children during their respective lifetimes and then for the benefit of their respective descendants. Each child was given the power to appoint the income among the descendants of the grantor, the spouses of those descendants, and charities. Child One died having exercised his power of appointment over one-half of the income of the parent Trust in favor of his descendants. Parent Trust continued to be administered as a single trust until year Y, distributing one-half of its income among the descendants of Child One and one-half to Child Two.

The trustees and beneficiaries of Parent Trust entered into a settlement agreement to split the Parent Trust into two trusts. Trust A was for the benefit of Child One's descendants and Trust B was for the benefit of Child Two.

The settlement agreement was contingent on a favorable state court order and on receipt of a private letter ruling stating that the division would not cause either Trust A or Trust B to lose its generation-skipping tax exemption. The favorable letter ruling was issued. No federal income tax rulings were requested or granted in the letter ruling.

Subsequently, the trustees of Trust B filed an additional petition requesting certain modifications including changing Child Two's limited testamentary power of appointment to an inter vivos power and asking that he be allowed to immediately exercise such inter vivos power to appoint X percent of the income and principal to Foundation One and Y percent to Foundation Two thus causing the trust to terminate. Each of Foundation One and Foundation Two were private foundations. Foundation One was preexisting while Foundation Two was newly created to receive funding when Trust B terminated. The Court approved the modification and termination of Trust B and the distribution of the trust assets to Foundation One and Foundation Two was completed.

On its original Form 1041, Trust B did not claim any deductions for the payments to Foundation One and Foundation Two. On its amended return for the year of termination, the trust claimed a deduction for the entire amount of income as a charitable income tax deduction less certain attorney and preparer fees.

The chief counsel advised that with respect to Section 642(c)(1), payments must be made pursuant to the terms of the governing instrument to be deductible under Section 642(c). The Chief Counsel stated that the payments would not qualify under Section 642(c), simply because they were pursuant to a modified governing instrument. It distinguished the Supreme Court's decision in Old Colony Trust Company v. Commissioner, 57 S. Ct. 813 (1937), because unlike Old Colony, there was no conflict with respect to Trust B subsequent to the division of the Parent Trust. The trust terms were unambiguous and the purpose of the court order was not to resolve a conflict but to obtain economic benefits which the parties believed they would receive from the modification of the Parent Trust. As a result, the modification was not presumed to be pursuant to a governing instrument because a modification arising from a conflict will be considered pursuant to the government instrument.

With respect to availability of the deduction under Section 661, the chief counsel said that although there is "genuine ambiguity" in the code and legislative history where the charitable payments have failed to meet the requirements of Section 642(c), whether they were deductible under Section 661, the better reading of the law was found in a regulation under Section 663 which indicates that Section 642(c) provides the only deduction available for charitable payments by estates and trusts.

84. Letter Ruling 201633021 (Issued April 29, 2016; Released August 12, 2016)

IRS rules on impact of power of withdrawal under Section 678(a)

Decedent established the original trust. Subsequently, a court ratified the division of the original trust into separate trusts for each child of the decedent and his or her spouse and issue. Trust 1 resulted from this division. The governing document for Trust 1 authorized the trustee to distribute all or any portion of the net income or principal of Trust 1 directly to any one or more of the beneficiaries living at the time of the distribution or to the trustees of any trust of which such beneficiary was the beneficiary. Pursuant to the authority granted to the trustee under the Trust 1 agreement, the trustee proposed to transfer funds from Trust 1 to Trust 2 which also benefited the beneficiaries. The beneficiaries' rights to distributions under the Trust 2 agreement were the same as those under the Trust 1 agreement.

The governing document of Trust 2 provided that Trust 1 retained the power, solely exercisable by Trust 1 to reinvest the net income of Trust 2 and Trust 1. This power would lapse on the last day of each calendar year.

The Trust 2 agreement provided that income included dividends, interest, fees, and other amounts characterized as income under Section 643(b) of the Code, any net capital gains realized

with respect to assets held less than 12 months, and any net capital gains realized with respect to assets of longer than 12 months.

Section 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of the trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Sections 671–677, subject a grantor of a trust the treatment as the owner thereof.

The IRS concluded that Trust 1 would be treated as the owner of the portion of Trust 2 over which the Trustee of Trust 1 had the power to withdraw under Section 678(a). As a result, Trust 1 would take into account in computing its tax liability, those items which would be included in computing the tax liability of Trust 2.

85. Letter Ruling 201710003 (Issued December 1, 2016; Released March 10, 2017)

Trust granted extension of time to make 65-day distribution election for irrevocable trust

In this letter ruling, an irrevocable trust filed its federal income tax return on a calendar year basis. The trustee of the trust made a distribution within the first sixty-five days of Year 2 and intended to have the Distribution considered to be paid or credited on the last day of Year 1 as permitted under Section 663(b). However, due to inadvertence, the Section 663(b) election was not timely made on the income tax return filed for the trust.

Applying the standards of Treas. Reg. §§ 301.9100-1 and 301.9100-3, the Service granted the request of the trust for an extension of time to make the distribution election. Under Treas. Reg. § 301.9100-3, relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interest of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. The IRS found that these requirements had been met.

86. Letter Ruling 201721003 (Issued February 7, 2017; Released May 26, 2017)

IRS grants extension of time to trust to make charitable contribution election

The trustee of an irrevocable trust made charitable contributions during Year 2. He intended to have the contributions to be considered to be paid in Year 1 as permitted under Section 642(c). However, due to inadvertence, the Section 642(c) election was not made. Under Section 642(c),

if a charitable contribution is paid after the close of a taxable year and on or before the last day of the year following the close of the taxable year, then the trustee may elect to treat such contribution as paid during the first taxable year. The election is made by filing with the income tax return a statement which states the name and address of the fiduciary, identifies the estate or trust for which the fiduciary is acting, indicates that the fiduciary is making an election with respect to contributions treated as paid during such taxable year, gives the name and address of each organization to which any contribution was paid, and states the amount of each contribution and the date of actual payment.

The IRS found here that the requirements of Treas. Reg. § 301.9100-1 and 301.9100-3 had been met. Relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and if the grant of the relief will not prejudice the interests of the government.

87. Letter Rulings 201730017 and 201730018 (Issued May 1, 2017; Released July 28, 2017)

Conversion of charitable lead annuity trust from a non-grantor trust for income tax purposes to a grantor trust for income tax purposes does not have adverse tax consequences to grantor

When a grantor creates a charitable lead annuity trust, the charitable annuity trust will either be a non-grantor trust for federal income tax purposes or a grantor trust. If the trust is a non-grantor trust for income tax purposes, the grantor will not receive an income tax charitable deduction when the trust is created but the trust is entitled to a charitable deduction for amounts paid for charitable purposes from gross income under Section 642(c)(1). If the charitable lead annuity trust is a grantor trust for federal income tax purposes, the grantor is entitled to claim an income tax charitable deduction in the taxable year in which the trust is created for the present value of the annuity interest.

In each of these letter rulings, the grantor established a charitable lead annuity trust as a non-grantor trust for income tax purposes. The trustees now sought to amend each trust to enable a substitutor to have the power, exercisable at any time in a non-fiduciary capacity within the meaning of Section 675(4) to substitute property of an equivalent value. The substitutor and the grantor are siblings.

The grantor, sought the following rulings:

1. The conversion of the charitable lead annuity trust from a non-grantor trust for federal income tax purposes to a grantor trust would not be treated as a transfer of property held by the trust to the grantor for federal income tax purposes;

2. The conversion of the trust from a non-grantor trust to a grantor trust was not an act of self-dealing that would result in tax under Section 4941 because the substitutor (the grantor's sibling) is not a disqualified person; and

3. The conversion of the trust from a non-grantor trust to a grantor trust would not result in an income tax charitable deduction for grantor in the year of conversion under Section 170.

With respect to the first ruling request, the Service held that there was no authority imposing consequences on the grantor when a trust changed from a non-grantor trust to a grantor trust. It did note that Revenue Ruling 77-402, 1977-2 C.B. 222 described the income tax effects of a lapse of grantor trust status during the grantor's life and income tax effects of a non-grantor trust becoming a grantor trust. Under that revenue ruling, the lapse of grantor trust status during the grantor's life may have income tax consequences but it does not impose those consequences on a non-grantor trust that becomes a grantor trust. In Revenue Ruling 85-13 1985-1 C.B. 184, the description of the income tax effects of a non-grantor trust becoming a grantor trust did not income any realization or recognition of any income by the grantor owner by reason of the conversion.

Charitable lead annuity trusts are subject to certain of the rules governing private foundations, including the self-dealing rules of Section 4941. In order for an act of self-dealing under Section 4941 to occur, the act needs to occur between a disqualified person and a private foundation. In analyzing the second request, the substitutor was not considered a disqualified person under Section 4946(a) because the substitutor is a sibling of the grantor and a sibling is not treated as a family member as described in Section 4946(d). Consequently, the conversion of the trust will not be an act of self-dealing under Section 4941 since no disqualified person is involved.

With respect to the third request, the Service ruled that the conversion of the trust from a non-grantor trust to a grantor trust can only result in an income tax charitable deduction if property has been transferred from the non-grantor trust to the grantor trust. Because the conversion of the charitable lead annuity trust from a non-grantor trust to a grantor trust is not a transfer of property held by the charitable lead annuity trust for income tax purposes, the grantor cannot take an income tax charitable deduction under Section 170(a).

The ruling did note that it was only limited to the conversion of the trust and it provided no opinion as to whether an act of self-dealing might occur upon the exercise of the power to substitute assets and that the Service was expressing no opinion regarding the federal gift tax consequences of the transaction, especially whether the proposed conversion would have any gift tax consequences to the grantor.

ASSET PROTECTION

88. Michigan Qualified Dispositions in Trust Act (December 5, 2016)

Michigan enacts domestic asset protection trust legislation

On December 5, 2016, Michigan's governor signed the Qualified Dispositions in Trust Act. This legislation will become effective on February 5, 2017.

Creditor Protection. For any irrevocable trust created on or after February 5, 2017, a grantor may provide that the income or principal interest of the grantor as beneficiary of the trust will be

protected from creditors. The trust must be irrevocable and there must be a Michigan trustee. The Michigan trustee must arrange for custody in Michigan of some or all of the trust property and some of the records pertaining to the trust must be kept in Michigan. No creditor or other person can bring a claim against a trustee, a trust advisor, a trust director, or any other person involved in counseling on, drafting, preparing, or executing the trust.

Limitations. The grantor can retain the following rights:

a. Direct trust and investment decisions;

b. Remove and replace trustees;

c. Veto distributions from the trust;

d. Receive discretionary distributions of income and/or principal;

e. Receive the income from the trust;

f. Retain a special testamentary power of appointment;

g. Receive an annuity or unitrust payment from a charitable remainder trust;

h. Receive the annuity payments from a grantor retained annuity trust; and

i. Receive an annuity from the trust of not more than 5 percent of the trust initial value.

Creditors have a two year period after a transfer to the trust to bring an action to challenge the transfer.

Applicability. The trust must provide that Michigan law applies to validity, construction, and administration of the trust. The trust must have a spendthrift provision.

Solvency Affidavit. At the creation of the qualified trust, the grantor must provide a solvency affidavit (called a "Qualified Affidavit") and indicate the following:

a. The grantor has the full right, title, and authority to transfer the property to the trust;

b. The transfer of the property to the trust will not render the grantor insolvent;

c. The grantor does not intend to defraud a creditor by transferring the property to the trust;

d. The grantor does not know of or have reason to know of any pending or threatened court actions against the grantor except to the extent identified in an attachment to the affidavit;

e. The grantor is not involved in any administrative proceedings except for administrative proceedings identified on an attachment to the affidavit;

f. The grantor is not currently in arrears on a child support obligation by more than 30 days;

g. The grantor does not contemplate filing for relief under the bankruptcy code; and

h. The property being transferred to the trust was not derived from unlawful activities.

Rule against Perpetuities. Michigan has repealed the rule against perpetuities with respect to personal property, effective May 28, 2008.

OTHER ITEMS OF INTEREST

89. United States v. Randy Read, 117 A.F.T.R.2d 2016-1218 (D. Conn. 2016)

Trustee was liable for unpaid taxes after rendering a trust insolvent when he knew that the trust had an unpaid tax liability

Read established a trust in 1999 for the benefit of his children and funded the trust with stock options earned by his wife. In 1999, the property in the trust was worth $700,000. In 2000, the trust filed a request for an extension of time to file its income tax return. The request showed a tax liability of $121,707. Read was aware of the amount of the tax liability in April 2001.

In April 2001, the assets of the trust were $225,170. On June 29, 2001, the value of the trust assets was $162,869.27. Read subsequently made payments from the trust for home renovations, to send his children to summer camp, and directly to himself.

The government moved for summary judgment and sought $175,042.16 plus interest because Read made payments from an insolvent trust that had an outstanding tax liability. The court granted the government's motion for summary judgment. It noted that Read was trustee of the trust which provided for discretionary distributions of income and principal. Read was the only person to have check signing authority for the trust. Read was aware of the tax liability of the trust and Read rendered the trust insolvent when he transferred $25,000 to himself on July 31, 2001 which reduced the trust assets below the amount of the tax liability.

The court found that Read was liable. A trustee will be liable for distributions "to the extent of the payment for unpaid claims" if a "reasonably prudent person" inquired "as to the existence of the debt owed." The court found that a reasonably prudent person would have inquired into the trust tax liability and whether the trust failure to pay would incur non-payment penalties. As a result, Read was liable for the entire amount of the debt owed by the trust which, by 2011, had

increased to $213,220.21. The court also found that Read was liable for prejudgment interest because Read was a self-dealing transferee of some of the trust distributions.

90. United States v. Estate of Espinor, 117 A.F.T.R.2d 2016-2142 (E.D. Cal. 2016)

Government granted default judgment against an estate and its co-executors and co-trustees and beneficiaries for the estate's unpaid federal estate tax liability

Cipriano Espinor died on October 13, 2004. After Cipriano's death, co-executors Michael C. Espinor and Toni Espinor Hicks administered the estate informally without court supervision and took actions with respect to the distribution of assets without court approval. Cipriano's will contained a pourover provision directing that the residuary assets were to be transferred into a family trust and distributed in accordance with its terms. Michael and Toni were co-trustees of the family trust. The family trust directed that the trustee was required to set aside sufficient assets to be used to pay federal estate tax, debts, and other obligations and directed the disposition of the remaining assets to the named defendants.

The total value of Cipriano's estate was $5,120,869. The estate filed a Section 6166 election to defer the payment of estate taxes for five years and thereafter to pay the remaining tax liability in ten annual installments on a portion of the estate. In this election, the total estate tax liability was calculated at $1,586,551, of which the estate elected to defer $622,563. The estate and the IRS negotiated agreements to secure the debts and for the IRS to enter liens to assure satisfaction which negotiations occurred over several years after 2006. In 2012, the IRS declared the estate to be in default of the installment agreement and terminated the installment agreement. The IRS subsequently sent a notice and demand for payment. The complaint asserted that various assets were distributed by the co-executors and co-trustees to themselves and others while the installment agreement was in effect. The transfers were described as having been made during a time when the estate lacked sufficient assets to pay its outstanding liabilities.

The court found that the estate was liable for $817,944.66 of unpaid federal estate taxes and that the co-executors and co-trustees distributed property of the estate and the Family Trust prior to fully paying the estate tax liabilities. It then found that the co-executors, the co-trustees, and the other recipients of property were jointly liable under Section 6324(a) for the amounts distributed to them before the estate tax obligation was satisfied.

91. Duckett v. Enomoto, 117 A.F.T.R.2d 2016-1999 (D. Ariz. 2016)

Court grants summary judgment to government on the issue of whether a federal tax lien attached to a delinquent taxpayer's right to funds in a testamentary trust established for him by his late mother

Dr. Dennis Enomoto failed to meet his tax obligations for the years 2007 through 2011. As a result, the IRS assessed $701,000 against Dr. Enomoto. Dr. Enomoto's mother passed away in

February 2013. Under the terms of his mother's will, one-third of her estate would be distributed to her son in a trust. Under the terms of the trust, Dr. Enomoto was to receive net income and principal of the trust in the sole discretion of the trustee as may be required for support in the beneficiary's accustomed manner of living, for medical, dental, hospital and nursing expenses, or for reasonable expenses of education, including study at the college and graduate levels. The trust was to terminate if the principal of the trust dropped below $10,000. A trust management services company was named as trustee. Dr. Enomoto's sister, Nancy Duckett, was named the executor of the estate.

The IRS sought to levy on the $173,545 that would pass to the trust created for Dr. Enomoto's benefit and the government moved for summary judgment directing that the funds be given to the IRS. Under Section 6321, the federal government may impose a lien on any "property" or "rights to property" belonging to a taxpayer. The court looked at the issue of whether the standard of distributions provided for in Dr. Enomoto's trust represented an ascertainable standard under Arizona law which would permit Dr. Enomoto to control distributions and would be considered a property right under Section 6321 or whether the distribution standard was fully discretionary and therefore distributions could not be controlled by Dr. Enomoto and consequently would not be a property right under Section 6321.

The court issued a decision that was partially favorable to the government and partially favorable to Dr. Enomoto. The court first found that the tax lien attached to the trust. The standard of distribution was an ascertainable standard and the trustee's withholding of distributions under the distribution standards would constitute an abuse of discretion in applying an ascertainable standard. The right to distributions under Arizona law created the necessary "property" or "rights in property" for Section 6321 to apply. However, while that right afforded Dr. Enomoto sufficient control of the trust funds to trigger the attachment of the federal tax lien, it did not, by itself justify enforcement of the lien as to any specific amount. Although Dr. Enomoto's right could be assigned a reasonably accurate dollar value by assessing the taxpayer's current needs and living demands, the IRS had failed to provide evidence of Dr. Enomoto's needs or demands and, therefore, there was no reason to think that the lien extended to all of the trust funds. As the court put it, the IRS had a valid lien, but that did not resolve the practical problem of enforcing the lien. The court held that the IRS would be granted a lien to the extent that the lien attached to Dr. Enomoto's right to the trust funds but would not yet be granted the right to a transfer of any funds to it. The amount subject to recovery remained to be determined.

92. United States v. Kimball, 118 A.F.T.R.2d 2016-5972 (D. Me. 2016)

Government's motion to enforce federal tax liens against trust created for benefit of taxpayer's children was denied

In this case, the government sought summary judgment first as to the amount of taxes, penalties and interest that John Kimball owed and second to enforce tax liens for those amounts against a trust of which Kimball was the grantor and previously was the trustee. The court granted the government's motion for summary judgment on the first issue, but denied it on the second issue.

With respect to the second issue, in 1989, Kimball, a Massachusetts resident, established the Kimball Family Realty Trust under Maine law. Kimball was the trustee and his five children were the beneficiaries. The purpose of establishing the family trust was to buy a ski condominium for his children. As the original trustee, Kimball had the power to alter or amend the trust. If the trust was revoked in whole or part, any revoked portion was to go to the children and not to Kimball. At the time that the trust was created, Kimball did not have any tax liability. Kimball and his wife separated in 1991 and Kimball resigned as trustee in 1993. Upon Kimball's resignation as trustee, the trust became irrevocable. Kimball paid the condominium expenses which were modest. When the beneficiaries were young and without driver's licenses, Kimball drove them to the ski condominium for family vacation time. Kimball either did not use or rarely used the condominium in the absence of the children and he never rented it to others to generate income. Kimball did not visit the ski condominium after 2001.

The government argued that when unpaid taxes are assessed, a federal tax lien attaches to all property and rights to property that the taxpayer then holds or subsequently acquires. It stated that the family trust was holding the ski condominium as Kimball's nominee and that the IRS should be able to enforce its tax liens on the condominium for Kimball's personal tax liabilities. The government did not argue that the creation or funding of the family trust was a fraudulent transfer.

The court noted that there was no direct statutory authority for nominee liens. The court also noted that before Maine enacted Uniform Trust Code, the presumption in Maine was that a trust was irrevocable unless stated otherwise. It noted that while the family trust document stated that the trust was revocable, there were two caveats. The first was that only the original trustee could revoke the trust and the second was that if the trust was revoked, the property went to the beneficiaries. Under no condition could the property revert to Kimball. The court also noted that the Maine Uniform Trust Code, which was adopted in 2005, reversed the presumption of irrevocability. The court could not determine that as a matter of law, after Kimball resigned as trustee in 1993, he had rights in the family trust property that would qualify as "property or rights to property" within the federal tax lien statute against which a lien could be enforced. This was a matter that would have to be determined.

93. <u>Specht v. United States</u>, 661 Fed. Appx. 357 (6th Cir. 2016)

Circuit Court upholds late filing penalties imposed on estate for late filing of an estate tax return when the individual executor relied on an attorney suffering from brain cancer

This action arose as a result of the IRS's motion for summary judgment. Virginia Escher passed away in 2008 with an estate worth $12,506,462 much of which consisted of UPS stock. Her cousin, Janice Specht, was appointed executor. Janice was then 73 and was a high school educated homemaker who had never served previously as an executor, owned no stock, and had never been in an attorney's office prior to witnessing Escher's will eight months before Escher's death. The attorney who prepared Escher's will was Mary Backsman. Specht selected Backsman to assist her in the administration of the estate. In January 2009, Backsman informed

Specht that the estate owed approximately $6 million in federal estate taxes and that the estate would need to liquidate its UPS shares in order to pay the liability. Backsman informed Specht that the estate taxes were due nine months following Escher's death on September 30, 2009. Backsman also suggested her law firm could pay the liability on the estate's behalf and seek reimbursement later. Specht formally accepted the duties of executor and signed the application for Authority to Administer Estate and the Fiduciary's Acceptance. The latter document laid out Specht's duties as an executor and included an attestation that Specht would file all tax documents as required by law.

Specht relied heavily on Backsman. Specht primarily called Backsman about the status of the matter. Whenever Specht asked about the filing of the tax return and payment, Backsman assured her that an extension had been obtained. Specht did not ask for proof that an extension had been obtained. Backsman's assurances turned out to be false. She never requested an extension. Backsman had over 50 years of experience in estate planning, but was privately battling brain cancer and did not inform Specht about her condition.

Prior to the estate tax filing deadline, Specht received four notices from the probate court informing her that the estate had missed probate deadlines. When Specht questioned Backsman, Backsman stated that she had obtained an extension and was handling the matter. In the nine months following the estate tax filing deadline, Specht received two more notices from the probate court informing her that Backsman failed to file a first accounting.

In July 2010, Specht received a call from friends who had also hired Backsman as an attorney for the estate of a family member. They warned Specht that Backsman was incompetent and told Specht that they were seeking to have Backsman removed as a co-executor of the family member's estate. Specht scheduled a meeting with Backsman and again Backsman represented that the execution of the estate was going smoothly. At this meeting, Backsman also had Specht sign a "blank paper" that Backsman stated would empower her to sell the UPS stock. Backsman later told Specht that she had sent a letter to UPS to initiate the sale of the stock.

On August 13, 2010, Specht received a notice from the Ohio Department of Taxation informing her that the Ohio state estate tax return was delinquent. Specht contacted Backsman who assured Specht that all was fine. Specht received two additional notices from the Ohio Department of Taxation and additional calls from other family members imploring her to fire Backsman. Specht also called UPS on October 27, 2010 and learned that the company had never received a letter from Backsman regarding the sale of the UPS stock. This was. At this point, Specht fired Backsman and hired a new attorney to represent the estate. It was only then, a year after the IRS filing deadline that Specht learned that the estate tax return had not been filed and that the taxes had not been paid. Within a month of hiring the new attorney, the estate liquidated the UPS stock and in 2011 filed its federal tax return and paid its tax liability and interest.

The IRS assessed penalties against the estate for failing to meet the September 30, 2009 deadline which the estate paid. It should be noted that he Ohio Department of Taxation fully refunded the estate's state penalties due to the hardship caused by Backman's representation. The estate settled a malpractice action against Backsman in 2012 and Backsman surrendered her law license.

This action was brought in the Southern District of Ohio in October 2013 to recover $1,189,261.38 in penalties and interest on the penalties assessed against the estate by the IRS. The district court granted the government's motion for summary judgment, concluding that Specht's reliance on Backsman to file the tax return and pay the tax liability was not a reasonable cause for the missed deadline. The district court also concluded that Specht's failure to supervise Backsman, despite the many warning signs of Backsman's deficient performance, constituted willful neglect of her duty to file the tax return and make the tax payment.

The circuit court upheld the district court's granting of the motion for summary judgment. The estate did not contest that it had failed to timely file or pay the estate tax. The only issue was whether the failures were due to "reasonable cause and not due to willful neglect." Under Section 6651(a), the penalties for failure to file a return or failure to pay a tax will not be owed if the taxpayer can establish that the failure is "due to reasonable cause and not due to willful neglect." The Sixth Circuit, as the district court had, relied on United States v. Boyle, 469 U.S. 241 (1985), in which the Supreme Court declared that "the time has come for rule with as "bright" a line as can be drawn." The Supreme Court noted that reliance by a lay person on a lawyer, while common, cannot function as a substitute for compliance with an unambiguous statute.

The estate attempted to distinguish Boyle on the basis that Specht was unqualified to be an executor and that Specht's reliance on Backsman was more reasonable than the reliance in the factual circumstances in Boyle and cases following Boyle. While Boyle left open the possibility that an executor's qualifications might impact the reasonable analysis, Justice Brennan's concurrence discussed taxpayers suffering from "senility, mental retardation or other causes" as examples of exceptional cases that might render an individual unable to comply with statutory deadlines.

The Sixth Circuit noted that while the executor in Boyle was a businessman who previously served as an executor, it was undisputed that the executor in Boyle was not experienced in the field of federal taxation and relied on his attorney for instruction and guidance. The estate also attempted to distinguish Boyle based on Backsman's tragic medical situation of suffering from brain cancer. To the Sixth Circuit, the relevant question was whether the executor, not the attorney, was reasonable in missing the deadline. It noted that, considering Specht's line of oversight, the deadline would have been missed even if Backsman had been healthy, but committed a clerical error such as the one that occurred in Boyle.

The court also noted that it had reinforced the strict bright line rule of Boyle in Valen Mfg. Co. v. United States, 90 F.3d 1190 (6th Cir. 1996) and in Vaughn v. United States, an unpublished decision in 2015, in which Mo Vaughn, a former major league baseball player, hired a wealth management firm and tax accountant to manage his finances, and prepare and file his tax returns, and make payments. Rather than paying taxes, the financial manager embezzled millions of dollars.

The Sixth Circuit rejected the estate's reliance on Brown v. Unites, 630 F. Supp. 57 (M.D. Tenn. 1985) which involved a 78 year old executor with a high school education and minimal

experience in tax matters. There the district court found that the executor's age, health, and lack of experience constituted reasonable cause for his failure to timely file the tax return. The Sixth Circuit noted that in Brown, the court found that the executor was not reasonably capable of hiring a new attorney after the attorney handling the estate was hospitalized two weeks prior to the filing deadline. It also noted that the executor's health had been deteriorating for years and that the executor and Brown had been under the care of several doctors while executor.

The Sixth Circuit acknowledged that Specht was the victim of "staggeringly inadequate legal counsel and there is no evidence of purposeful delay." However, the bright line test applied in Boyle, Valen, and Vaughn, made it clear that the duties to file a tax return and pay taxes are not delegable and mere good faith reliance does not constitute reasonable cause.

94. United States v. Spoor, 838 F.3d 1197 (11th Cir. 2016)

Appellate court holds that special estate tax liens under Section 6324A are not subject to an executor's claims for administrative expenses, and that the executors' administrative expenses do not take priority over income tax liens

Louise Paxton Gallagher died in 1989. Her revocable trust upon her death contained 39,700 units in Paxton Media Group LLC. F. Gordon Spoor was the personal representative of the estate and the trustee of the revocable trust. On September 30, 2005, Spoor filed the Form 706. The LLC interests in Paxton Media Group were valued on the estate tax return at $34,936,000. The total value of the estate as listed on the federal estate tax return was $36,624,546. The IRS challenged the valuation of the LLC units and the Tax Court valued the LLC units at $35,761,760. This resulted in an additional estate tax liability of $401,743.89.

The estate elected to defer and pay its estate tax liability in ten equal installments under Section 6166. The estate made tax payment in 2006, 2007 and 2008. In 2010, the estate agreed to the creation of a special deferred estate tax lien on the LLC units under Section 6324A. The IRS recorded the notice of the lien. By 2012, the value of the units had become less than the unpaid portion of deferred tax and interest. The IRS demanded additional collateral from the estate. The estate was unable to provide the additional collateral and the IRS accelerated the remaining estate tax owed of $10,483,006. The estate also failed to pay reported income taxes and owed an additional $551,106 in income tax, penalties, and interest. Pursuant to Section 6321, the failure to pay income tax liabilities resulted in federal tax liens attaching to the estate beginning on September 20, 2010.

The government sought to foreclose the designated property lien under Section 6324A and the income tax liens. Spoor did not dispute the validity or amount of the IRS liens and the district court granted summary judgment to the United States on its rights to foreclose its tax lien. Spoor filed a cross-motion for summary judgment, asserting his claim that administrative expenses took priority over the government's liens. At the time of the summary judgment, Spoor had paid himself $600,000 of his $1,086,265 claim. This left $486,265 yet to be paid. At this time, the value of the Paxton units had fallen to approximately $2,000,000. In the court's view, because the estate taxes took priority over the unpaid income taxes, and the estate's assets were

insufficient to cover both the estate taxes and Spoor's commission, the key question was whether estate taxes took priority over Spoor's commissions. The district court entered summary judgment in favor of Spoor. It indicated that Section 6324A is "silent as to priority of claims which arise prior to a federal tax lien." The district court relied on the common law principle that "the first in time is the first in right."

The appellate court disagreed. It stated that the text and structure of Section 6324A do not permit an executor's administrative expenses to primacy over a Section 6324A estate tax lien. It also noted that although Section 6324A does not mention administrative expenses, some United States Supreme Court decisions suggest that the common law principle applies when a statute is silent on liens. It determined that Spoor's claims for commissions was not a lien and therefore not governed by the principle.

95. United States v. Johnson, 224 F.Supp.3d 1220 (D. Utah December 1, 2016)

District Court rules on validity of IRS claims against heirs of estate for estate tax deficiency

Anna S. Smith died on September 2, 1991. The major asset that she left to her four children through her revocable trust were shares of stock in the State Line Hotel which was a holder of a Nevada gaming license. Two of her children, Mary Carol S. Johnson and James W. Smith, were named as personal representatives and trustees. In 1992, the trustees filed the federal estate tax return which showed a gross value for the estate of $15,958,765. This resulted in a federal estate tax liability of $6,631,448. Four million dollars of the tax was paid upon filing. Because the majority of the estate consisted of closely-held stock in the hotel, which had been valued at $11,508,400, the trustees elected to defer payment of the remaining federal estate tax under Section 6166.

While under Nevada law, trustees are not supposed to hold stock in a casino, the trust and the trustees had received special permission for their continued ownership in the hotel that would expire in January 1993. As a result, the trustees on December 31, 1992 executed a distribution agreement which indicated the beneficiaries would receive the stock and would be responsible for the deferred federal estate tax at the same time. Also, an additional $1,000,000 in deferred estate tax was paid to the IRS.

In 1995, the IRS claimed that the hotel stock was worth $15,500,000 rather than the $11,508,400 claimed on decedent's federal estate tax return. The estate ultimately settled at a value of the stock for which additional federal estate taxes of $240,381 were to be paid.

The trustees had various discussions with the IRS as to whether the closely held hotel stock could be used as security for a special lien for the deferred estate tax under Section 6324A. Eventually, the lien was placed on the stock. In January 2002, the hotel filed for bankruptcy. As a result of the bankruptcy proceedings, the beneficiaries were instructed to cease payments on the remaining deferred estate tax liability. The beneficiaries applied for an extension of time to pay the next installment under Section 6166 and notified the IRS that the hotel was in bankruptcy proceedings.

A year after the conclusion of the bankruptcy proceedings, the IRS sent the trustees delinquent billing notices for the outstanding estate taxes due. The installment payment was not made in 2003. In 2005, the estate communicated with the IRS about the inability of the estate to pay its outstanding estate taxes. Subsequently, the IRS sent a notice of levy to each of the four children. The levy attached assets includible in the gross estate of Anna Smith and included, but was not limited to, cash and insurance proceeds. The IRS made several efforts to collect the estate's outstanding tax liability, including a lawsuit in which causes of action against all defendants for trustee, transferee, and beneficiary liability were asserted. Causes of action were also asserted against the personal representatives.

After much discussion in an examination of the procedural issues, the court first found that the trustees of the trust were not liable for the unpaid federal estate tax and interest because the trust assets were included in the gross estate under Section 2033. In addition, it found that the trustees of the trust were discharged from personal liability for the unpaid federal estate tax because they properly furnished a special lien under Section 6324A. The court then permitted the government to recover the life insurance proceeds received by the two children who were then living. The court also permitted fiduciary liability claims against the personal representatives.

96. Estate of Rubin A. Meyers v. Commissioner, T.C. Memo 2017-11

Recipients of assets received by means other than a will or state law governing the distribution of a deceased person's property could be liable for unpaid estate taxes ten years later

Rubin A. Meyers died in November 2005. On February 15, 2007, the executor filed a federal estate tax return and began making installment payments pursuant to Section 6166. In 2007 through 2013, the estate made the required payments. In 2014, the estate became delinquent. A revenue officer was assigned to collect the delinquent payments. On October 7, 2014, the revenue officer filed the Notes of the Federal Tax Lien ("NFTL") and shortly thereafter notified the executor that the NFTL had been filed and of this right to a Collection Due Process ("CDP") hearing. On October 29, 2014, the revenue officer notified the executor of the IRS's intent to levy to collect the delinquent tax and of his right to a CDP hearing. The unpaid liability for estate tax, interest, and penalties was then $380,000. The estate timely submitted a request for a CDP hearing asking for an offer in compromise and stating that he was unable to pay the balance due and requesting withdrawal of the NFTL.

After the submission of the request form, the revenue officer made an inappropriate contact with the settlement officer assigned to conduct the CDP hearing. As a result, the case was assigned to another settlement officer. A face to face meeting was set for April 9, 2015. Prior to the hearing, the executor provided the settlement officer with the financial information but did not submit a completed offer in compromise.

At the hearing, the executor stated that, paying the delinquent estate tax liability from probate assets would require the sale of family farm lands that would be difficult to liquidate. He suggested that the IRS take action to collect the delinquent liability from third parties that had

received cash or liquid non-probate assets. He also represented that he had no access to non-probate assets as a source of funds to pay the estate tax liability. As a result of the hearing, the settlement officer determined that the estate did not qualify for non-collectible status or hardship, but that the IRS could pursue collection of the estate tax from non-probate assets. The NFTL was kept in place because the petitioner had not provided sufficient justification for withdrawal.

The special estate tax lien against the family farm expired on November 15, 2015, ten years after decedent's death. The IRS had not taken any action to attach or otherwise collect the estate tax liability with respect to the non-probate assets. The court held that while the ten year period for imposing personal liability could still be open after expiration of the ten year special estate tax lien against the family farm and the probate estate. Although the lien begins to run as of the date of death, the ten year collection period runs from the date of assessment.

97. Estate of Hake v. United States, 234 F.Supp.3d 626 (M.D. Pa. February 10, 2017)

Estate granted abatement of penalties for late filing

This action was brought on cross motions for summary judgment. Two children were acting as executors of their late mother's estate sued the government seeking abatement and reimbursement of a penalty that was assessed after the executors were late in filing the estate's tax returns.

The executors did not neglect to comply with a deadline that was known to them. Instead, the executors filed the return on the date that their tax attorney advised them it was due, after the estate had been granted extensions of time for both filing of the tax return and payment of the tax. According to the court, the executors took care to pay the taxes they believed were owed well before the payment was due and in an amount later proved to be more than $100,000 in excess of what was actually owed. Nevertheless, the executors unquestionably filed the estate's return approximately six months late having been incorrectly advised by a tax professional that the return deadline had also been extended for one year, something that was admittedly inaccurate, and in fact was generally unavailable under the governing tax laws. For this error, the executors were accessed a late penalty in the amount of $197,862.26 and interest of $17,202.44. The court found that the executors relied upon the advice of their counsel and the particular circumstances of this case regarding the applicable deadlines for filing the estate tax return was reasonable, and therefore, the imposition of penalties and interest was not warranted. In reaching this conclusion, the court acknowledged the arguments of the government regarding the application of emerging case law from other courts in this field but found the authority of the Third Circuit Court of Appeals (in which this district court was located) to the particular facts of this case compelled this outcome.

Under Section 6651(a)(1) when a taxpayer fails to file a tax return by the due date, including any extension of time for filing, the late penalty applies "unless it is shown that such failure is due to reasonable cause and not due to willful neglect." The Supreme Court in United States v. Boyle, 469 U.S. 241 noted that in order to gain the benefit of this exception, the executor bears "the

heavy burden of proving … that the failure to file was due to "reasonable cause." Reasonable cause will excuse failure to file timely only if the taxpayer exercised ordinary business care and prudence but was nevertheless unable to file the return within the prescribed time. The Third Circuit addressed this in the Estate of Thouron v. United States, 752 F. 3d. 311 (3d CR 2014). Thouron noted three categories of late filing cases. The first category involves taxpayers who delegate the task of filing a return to an agent and the agent files the return late or not at all. The second category is where a taxpayer relies on the advice of an accountant or attorney, and files a return after the actual due date but within the time that the taxpayer's lawyer or accountant advised the taxpayer was available. The third category is where an accountant or attorney advises a taxpayer on a matter of tax law.

In Thouron, the Third Circuit construed Boyle narrowly and instructed that Boyle only addresses cases of clerical oversight where a taxpayer has simply relied on a third-party to file a return by the prescribed deadline. The court distinguished the facts in this case from Boyle because in Boyle that the Supreme Court declined to address the question of whether a taxpayer demonstrates "reasonable cause" when it relies upon the advice of counsel and files the return after the actual due date but within the time the advisor erroneously told him was available." Here, following Thouron, the court held in favor of the executors. It did note that other courts have interrupted Boyle in the manner urged by the government.

98. Estate of Ackerley v. Department of Revenue, No. 92791-0 (Wash. February 16, 2017)

Gift tax paid within three years of death is part of the Washington taxable estate and subject to Washington estate tax

Ackerley died on March 21, 2011. In 2008 and 2010, Ackerley had made substantial gifts and paid the required federal gift taxes which amounted to over $5.5 million. Upon his death, Ackerley's estate was required under the federal estate tax code to include the value of the gift taxes paid in his federal taxable estate because Ackerley died within three of making the gifts. Ackerley's estate thus included the gift taxes in its federal estate tax return. When Ackerley's estate filed his Washington estate tax return, it did not include the $5.5 million in federal gift taxes paid as part of the Washington taxable estate. The Washington Department of Revenue issued a notice of assessment, notifying Ackerley's estate that it owed additional Washington estate taxes on the amount of the federal gift taxes paid.

Ackerley's estate disputed this claiming that the Washington estate tax was imposed only on "transfers" of property and the payment of gift taxes within three years of death was not a transfer of property. The Washington Supreme Court upheld the lower court's decision that Ackerley's estate was required to pay Washington State estate tax on federal gift taxes paid with three years of death because those federal gift taxes paid within three years of death fall within the definitions of "transfer" and "Washington taxable estate." It noted that just as the federal taxable estate is "grossed up" for estate purposes with gift taxes paid within three years of death, so too is the Washington taxable estate. The court found that in establishing its separate state estate tax in 2005, the federal gift tax paid within three years of death is included in both the

"federal taxable estate" and "Washington taxable estate" because the legislature clearly defined the two as the same. In addition, because the federal and Washington estate taxes are imposed on transfers from the taxable estate, it was also clear that the gift taxes paid within three years of death transferred with the rest of Ackerley's estate because the legislature clearly intended a broad definition of "transfer," consistent with federal law. The court cited Fernandez v. Wiener, 326 U.S. 340 (1945) to show that the definition of transfer is a broad requirement. In Fernandez, the United States Supreme Court stated:

> The power of Congress to impose death taxes is not limited to taxation of transfers at death. It extends to the creation, exercise, acquisition, or relinquishment of any power or legal privilege which is incident to the ownership of property, and when any of these is occasioned by death, it may as readily be the subject of the federal tax as the transfer of property at death.

Because the gift taxes paid within three years of death transferred with the rest of the taxable of estate at Ackerley's death, they were subject to Washington estate tax.

99. Changes in State Death Taxes in 2016 and 2017

New Jersey has repealed its estate tax effective January 1, 2018. For 2017, the New Jersey threshold is $2,000,000 up from $675,000 in 2016. New Jersey did not repeal its inheritance tax. Delaware passed legislation in 2017 to sunset its estate tax as of January 1, 2018. Minnesota increased its exemption for 2017 from $1,800,000 to $2,100,000 retroactively, and increases its exemption to $2,400,000 in 2018, $2,700,000 in 2019, and $3,000,000 in 2020 and thereafter.

100. 2017 State Death Tax Chart

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
Alabama	None	Tax is tied to federal state death tax credit. AL ST § 40-15-2.		
Alaska	None	Tax is tied to federal state death tax credit. AK ST § 43.31.011.		
Arizona	None	Tax was tied to federal state death tax credit. AZ ST §§ 42-4051; 42-4001(2), (12). On May 8, 2006,		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		Governor Napolitano signed SB 1170 which permanently repealed Arizona's state estate tax.		
Arkansas	None	Tax is tied to federal state death tax credit. AR ST § 26-59-103; 26-59-106; 26-59-109, as amended March, 2003.		
California	None	Tax is tied to federal state death tax credit. CA REV & TAX §§ 13302; 13411.		
Colorado	None	Tax is tied to federal state death tax credit. CO ST §§ 39-23.5-103; 39-23.5-102.		
Connecticut	Separate Estate Tax	As part of the two year budget which became law on September 8, 2009, the exemption for the separate estate and gift taxes was increased to $3.5 million, effective January 1, 2010, the tax rates were reduced to a spread of 7.2% to 12%, and effective for decedents dying on or after January 1, 2010, the Connecticut tax is due six months after the date of death. CT ST § 12-391. In May 2011, the threshold was lowered to $2 million retroactive to January 1, 2011.	On July 10, 2015, the Connecticut Governor signed Senate Bill 1502 which implemented the biannual budget. The budget bill included a $20 million dollar cap on the amount of Connecticut estate and gift tax for both residents and nonresidents. This cap will be effective for decedents dying on or after January 1, 2016. It is	$2,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
			estimated that the tax cap will affect taxable estates greater than $170.5 million. The Connecticut exemption remains at $2 million.	
Delaware	Pick up Only Sunsets on December 31, 2017	For decedents dying after June 30, 2009. The federal deduction for state death taxes is not taken into account in calculating the state tax. DE ST TI 30 §§ 1502(c)(2).	On July 2, 2017, the Governor signed HB 16 which sunsets the Delaware Estate Tax on December 31, 2017.	$5,490,000 (indexed for inflation)
District of Columbia	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001. In 2003, tax imposed only on estates exceeding EGTRRA applicable exclusion amount. Thereafter, tax imposed on estates exceeding $1 million. DC CODE §§ 47-3702; 47-3701; approved by Mayor on June 20, 2003; effective retroactively to death occurring on and after January 1, 2003. No separate state QTIP election.	On June 24, 2015, the D.C. Council approved changes to the D.C. Estate Tax. The changes include possible increases in the D.C. estate tax threshold to $2 million in 2016 and to the federal threshold of $5 million indexed for inflation in 2018 or later. Both increases	$2,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
			are subject to the District meeting or exceeding certain revenue targets. The target for increasing the exemption to $2,000,000 was met in 2016 and became effective in 2017.	
Florida	None	Tax is tied to federal state death tax credit. FL ST § 198.02; FL CONST. Art. VII, Sec. 5		
Georgia	None	Tax is tied to federal state death tax credit. GA ST § 48-12-2.		
Hawaii	Modified Pick-up Tax	Tax was tied to federal state death tax credit. HI ST §§ 236D-3; 236D-2; 236D-B The Hawaii Legislature on April 30, 2010 overrode the Governor's veto of HB 2866 to impose a Hawaii estate tax on residents and also on the Hawaii assets of a non-resident or a non US citizen.	On May 2, 2012, the Hawaii legislature passed HB2328 which conforms the Hawaii estate tax exemption to the federal estate tax exemption for decedents dying after January 25, 2012.	$5,490,000 (indexed for inflation for deaths occurring after January 25, 2012)
Idaho	None	Tax is tied to federal state death tax credit. ID ST §§ 14-403; 14-402; 63-3004 (as amended Mar. 2002).		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
Illinois	Modified Pick-up Only	On January 13, 2011, Governor Quinn signed Public Act 096-1496 which increased Illinois' individual and corporate income tax rates. Included in the Act was the reinstatement of Illinois' estate tax as of January 1, 2011 with a $2 million exemption. Senate Bill 397 passed both the Illinois House and Senate as part of the tax package for Sears and CME on December 13, 2011. It increased the exemption to $3.5 million for 2012 and $4 million for 2013 and beyond. Governor Quinn signed the legislation on December 16, 2011. Illinois permits a separate state QTIP election, effective September 8, 2009. 35 ILCS 405/2(b-1).		$4,000,000
Indiana	None	Pick-up tax is tied to federal state death tax credit. IN ST §§ 6-4.1-11-2; 6-4.1-1-4.	On May 11, 2013, Governor Pence signed HB 1001 which repealed Indiana's inheritance tax retroactively to January 1, 2013. This replaced Indiana's prior	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
			law enacted in 2012 which phased out Indiana's inheritance tax over nine years beginning in 2013 and ending on December 31, 2021 and increased the inheritance tax exemption amounts retroactive to January 1, 2012.	
Iowa	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. IA ST § 451.2; 451.13. Effective July 1, 2010, Iowa specifically reenacted its pick-up estate tax for decedents dying after December 31, 2010. Iowa Senate File 2380, reenacting IA ST § 451.2. Iowa has a separate inheritance tax on transfers to others than lineal ascendants and descendants.		
Kansas	None	For decedents dying on or after January 1, 2007 and through December 31, 2009, Kansas had enacted a separate stand alone estate tax. KS ST § 79-15, 203		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
Kentucky	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. KY ST § 140.130. Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.		
Louisiana	None	Pick-up tax is tied to federal state death tax credit. LA R.S. §§ 47:2431; 47:2432; 47:2434.		
Maine	Pick-up Only	For decedents dying after December 31, 2002, pick-up tax was frozen at pre-EGTRRA federal state death tax credit, and imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003). On June 20, 2011, Maine's governor signed Public Law Chapter 380 into law, which will increase the Maine estate tax exemption to $2 million in 2013 and beyond. The rates were also changed, effective January 1, 2013, to 0% for Maine estates up to $2		$5,490,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		million, 8% for Maine estates between $2 million and $5 million, 10 % between $ 5 million and $8 million and 12% for the excess over $8 million. On June 30, 2015, the Maine legislature overrode the Governor's veto of LD 1019, the budget bill for fiscal years 2016 and 2017. As part of the new law, the Maine Exemption is tagged to the federal exemption for decedents dying on or after January 1, 2016. The tax rates will be: 8% on the first $3 million above the Maine Exemption; 10% on the next $3 million above the Maine Exemption; and !2% on all amounts above $6 million above the Maine Exemption. The new legislation did not include portability as part of the Maine Estate Tax. For estates of decedents dying after December 31, 2002, Sec. 2058		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062. Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non resident's estate. M.R.S. Title 36, Sec. 4064.		
Maryland	Pick-up Tax Inheritance Tax	On May 15, 2014, Governor O'Malley signed HB 739 which repealed and reenacted MD TAX GENERAL §§ 7-305, 7-309(a), and 7-309(b) to do the following: 1. Increases the threshold for the Maryland estate tax to $1.5 million in 2015, $2 million in 2016, $3 million in 2017, and $4 million in 2018. For 2019 and beyond, the Maryland threshold will equal the federal applicable exclusion amount.		$3,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		2. Continues to limit the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds the Maryland threshold unless the Section 2011 federal state death tax credit is then in effect. 3. Continues to ignore the federal deduction for state death taxes under Sec. 2058 in computing Maryland estate tax, thus eliminating a circular computation. 4. Permits a state QTIP election.		
Massachusetts	Pick-up Only	For decedents dying in 2002, pick-up tax is tied to federal state death tax credit. MA ST 65C §§ 2A. For decedents dying on or after January 1, 2003, pick-up tax is frozen at		$1,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		federal state death tax credit in effect on December 31, 2000. MA ST 65C §§ 2A(a), as amended July 2002. Tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev. Massachusetts Department of Revenue has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state's new estate tax based upon pre-EGTRRA federal state death tax credit.		
Michigan	None	Tax is tied to federal state death tax credit. MI ST §§ 205.232; 205.256		
Minnesota	Pick-up Only	Tax frozen at federal state death tax credit in effect on December 31, 2000,	On May 30, 2017, the governor	$2,100,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		clarifying statute passed May 2002. Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. MN ST §§ 291.005; 291.03; instructions for MS Estate Tax Return; MN Revenue Notice 02-16. Separate state QTIP election permitted.	signed the budget bill, H.F. No. 1 which increased the Minnesota estate tax exemption for 2017 from $1,800,000 to $2,100,000 retroactively, and increases the exemption to $2,400,000 in 2018, $2,700,000 in 2019, and $3,000,000 for 2020 and thereafter. A provision enacted in 2013 to impose an estate tax on non-residents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota was amended in 2014 to exclude certain publicly traded entities. It still applies to entities taxed	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
			as partnerships or S Corporations that own closely held businesses, farms, and cabins.	
Mississippi	None	Tax is tied to federal state death tax credit. MS ST § 27-9-5.		
Missouri	None	Tax is tied to federal state death tax credit. MO ST §§ 145.011; 145.091.		
Montana	None	Tax is tied to federal state death tax credit. MT ST § 72-16-904; 72-16-905.		
Nebraska	County Inheritance Tax	Nebraska through 2006 imposed a pick-up tax at the state level. Counties impose and collect a separate inheritance tax. NEB REV ST § 77-2101.01(1).		
Nevada	None	Tax is tied to federal state death tax credit. NV ST Title 32 §§ 375A.025; 375A.100.		
New Hampshire	None	Tax is tied to federal state death tax credit. NH ST §§ 87:1; 87:7.		
New Jersey	Pick-up Tax Inheritance Tax	For decedents dying after December 31, 2002, pick-up tax frozen at federal state death tax credit in effect on December 31, 2001. NJ ST § 54:38-1	On October 14, Governor Christie signed Assembly Bill A-12 which was the tax bill	$2,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		Pick-up tax imposed on estates exceeding federal applicable exclusion amount in effect December 31, 2001 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. The exemption will be increased to $2 million in 2017 and the pick-up tax, but the inheritance tax, will be eliminated as of January 1, 2018. The executor has the option of paying the above pick-up tax or a similar tax prescribed by the NJ Dir. Of Div. of Taxn. NJ ST § 54:38-1; approved on July 1, 2002. In Oberhand v. Director, Div. of Tax, 193 N.J. 558 (2008), the retroactive application of New Jersey's decoupled estate tax to the estate of a decedent dying prior to the enactment of the tax was declared "manifestly unjust", where the will included marital formula provisions.	accompanying the Assembly Bill A-10 which revised the funding for the state's Transportation Fund. Under this new law, the Pick-Up Tax will have a $2 million exemption in 2017 and will be eliminated as of January 1, 2018. The new law also eliminates the tax on New Jersey real and tangible property of a non-resident decedent. The repeal of the pick-up tax does not apply to the separate New Jersey inheritance tax.	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		In Estate of Stevenson v. Director, 008300-07 (N.J.Tax 2-19-2008) the NJ Tax Court held that in calculating the New Jersey estate tax where a marital disposition was burdened with estate tax, creating an interrelated computation, the marital deduction must be reduced not only by the actual NJ estate tax, but also by the hypothetical federal estate tax that would have been payable if the decedent had died in 2001. New Jersey allows a separate state QTIP election when a federal estate tax return is not filed and is not required to be filed. The New Jersey Administrative Code also requires that if the federal and state QTIP election is made, they must be consistent. NJAC 18:26-3A.8(d)		
New Mexico	None	Tax is tied to federal state death tax credit. NM ST §§ 7-7-2; 7-7-3.		
New York	Pick-up Only	Tax frozen at federal state death tax credit in effect on July 22, 1998. NY TAX § 951.	The Executive Budget of 2014-2015 which was signed by	$4,187,500 (April 1, 2016 through March 31,

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		Governor signed S. 6060 in 2004 which applies New York Estate Tax on a *pro rata* basis to non-resident decedents with property subject to New York Estate Tax. On March 16, 2010, the New York Office of Tax Policy Analysis, Taxpayer Guidance Division issued a notice permitting a separate state QTIP election when no federal estate tax return is required to be filed such as in 2010 when there is no estate tax or when the value of the gross estate is too low to require the filing of a federal return. See TSB-M-10(1)M. Advisory Opinion (TSB-A-08(1)M (October 24, 2008) provides that an interest in an S Corporation owned by a non-resident and containing a condominium in New York is an intangible asset as long as the S Corporation has a real business purpose. If the S Corporation has no business purpose, it appears that New York would look through the S Corporation and subject the condominium to New	Governor Cuomo on March 31, 2014 made substantial changes to New York's estate tax. The New York estate tax exemption which was $1,000,000 through March 31, 2014 has been increased as follows: April 1, 2014 to March 31, 2015 -- $2,062,500 April 1, 2015 to March 31, 2016 -- $3,125,000 April 1, 2016 to March 31, 2017 -- $4,187,500 April 1, 2017 to December 31, 2018 -- $5,250,000 As of January 1, 2019, the New York	2017) $5,250,000 (April 1, 2017 through December 31, 2018)

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		York estate tax in the estate of the non-resident. There would likely be no business purpose if the sole reason for forming the S Corporation was to own assets.	estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount. The maximum rate of tax will continue to be 16%. Taxable gifts within three years of death between April 1, 2014 and December 31, 2018 will be added back to a decedent's estate for purposes of calculating the New York tax. The New York estate tax will be a cliff tax. If the value of the estate is more than 105% of the then current exemption, the exemption will not be available. On April 1,	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
			2015, as part of 2015-2016 Executive Budget, New York enacted changes to the New York Estate Tax. New York first clarified that the new rate schedule enacted in 2014 applies to all decedents dying after April 1, 2014. Previously, the rate schedule only applied through March 31, 2015. New York then modified the three year gift add-back provision to make it clear that the gift add-back does not apply to any individuals dying on or after January 1, 2019. Previously, the gift add-back provision did not apply to gifts made on or after January 1, 2019.	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
			New York continues to not permit portability for New York estates and no QTIP election is allowed.	
North Carolina	None		On July 23, 2013, the Governor signed HB 998 which repealed the North Carolina estate tax retroactively to January 1, 2013.	
North Dakota	None	Tax is tied to federal state death tax credit. ND ST § 57-37.1-04		
Ohio	None	Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax prospectively and granting credit for it retroactively. This was effective June 30, 2005 and killed the sponge tax. On June 30, 2011, Governor Kasich signed HB 153, the biannual budget bill, which contained a repeal of the Ohio state estate tax effective January 1, 2013.		
Oklahoma	None	Tax is tied to federal state		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		death tax credit. OK ST Title 68 § 804 The separate estate tax was phased out as of January 1, 2010.		
Oregon	Separate Estate Tax	On June 28, 2011, Oregon's governor signed HB 2541 which replaces Oregon's pick-up tax with a stand-alone estate tax effective January 1, 2012. The new tax has a $1 million threshold with rates increasing from ten percent to sixteen percent between $1 million and $9.5 million. Determination of the estate for Oregon estate tax purposes is based upon the federal taxable estate with adjustments.		$1,000,000
Pennsylvania	Inheritance Tax	Tax is tied to the federal state death tax credit to the extent that the available federal state death tax credit exceeds the state inheritance tax. PA ST T. 72 P.S. § 9117 amended December 23, 2003. Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax which is independent of the federal		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		state death tax credit. Pennsylvania recognizes a state QTIP election.		
Rhode Island	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001, with certain adjustments (see below). RI ST § 44-22-1.1. Rhode Island recognized a separate state QTIP election in the State's Tax Division Ruling Request No. 2003-03. Rhode Island's Governor signed into law HB 5983 on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U). . . rounded up to the nearest five dollar ($5.00) increment." RI ST § 44-22-1.1.	On June 19, 2014, the Rhode Island Governor approved changes to the Rhode Island Estate Tax by increasing the exemption to $1,500,000 indexed for inflation in 2015 and eliminating the cliff tax.	$1,515,156
South Carolina	None	Tax is tied to federal state death tax credit.		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		SC ST §§ 12-16-510; 12-16-20 and 12-6-40, amended in 2002.		
South Dakota	None	Tax is tied to federal state death tax credit. SD ST §§ 10-40A-3; 10-40A-1 (as amended Feb. 2002).		
Tennessee	None	Pick-up tax is tied to federal state death tax credit. TN ST §§ 67-8-202; 67-8-203. Tennessee had a separate inheritance tax which was phased out as of January 1, 2016.	On May 2, 2012, the Tennessee legislature passed HB 3760/SB 3762 which phased out the Tennessee Inheritance Tax as of January 1, 2016. The Tennessee Inheritance Tax Exemption was increased to $1.25 million in 2013, $2 million in 2014, and $5 million in 2015. On May 2, 2012, the Tennessee legislature also passed HB 2840/SB2777 which repealed the Tennessee state gift tax retroactive to January 1,	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
			2012.	
Texas	None	Tax was permanently repealed effective as of September 15, 2015 when Chapter 211 of the Texas Tax Code was repealed. Prior to September 15, 2015, the tax was tied to the federal state death tax credit.		
Utah	None	Tax is tied to federal state death tax credit. UT ST § 59-11-102; 59-11-103.		
Vermont	Modified Pick-up	In 2010, Vermont increased the estate tax exemption threshold from $2,000,000 to $2,750,000 for decedents dying January 1, 2011. As of January 1, 2012 the exclusion is scheduled to equal the federal estate tax applicable exclusion, so long as the FET exclusion is not less than $2,000,000 and not more than $3,500,000. VT ST T. 32 § 7442a. Previously the estate tax was frozen at federal state death tax credit in effect on January 1, 2001. VT ST T. 32 §§ 7402(8), 7442a, 7475, amended on June 21, 2002. No separate state QTIP election permitted.		$2,750,000
Virginia	None	Tax is tied to federal state death tax credit.		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		VA ST §§ 58.1-901; 58.1-902. The Virginia tax was repealed effective July 1, 2007. Previously, the tax was frozen at federal state death tax credit in effect on January 1, 1978. Tax was imposed only on estates exceeding EGTRRA federal applicable exclusion amount. VA ST §§ 58.1-901; 58.1-902.		
Washington	Separate Estate Tax	On February 3, 2005, the Washington State Supreme Court unanimously held that Washington's state death tax was unconstitutional. The tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002–2004 and eliminating it for the years 2005–2010. Hemphill v. State Department of Revenue, 153 Wash.2d 544 (Wash. 2005). In response to Hemphill, the Washington State Senate on April 19 and the Washington House on April 22, 2005, by narrow majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million	On June 14, 2013, Governor Inslee signed HB 2075 which closed an exemption for marital trusts retroactively immediately prior to when the Department of Revenue was about to start issuing refund checks, created a deduction for up to $2.5 million for certain family owned businesses and indexes the $2 million Washington state death tax	$2,129,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A election could have been taken (regardless of whether the election is made). The Governor signed the legislation. WA ST §§ 83.100.040; 83.100.020. Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections. Washington permits a separate state QTIP election. WA ST §83.100.047.	threshold for inflation.	
West Virginia	None	Tax is tied to federal state death tax credit. WV § 11-11-3.		
Wisconsin	None	Tax is tied to federal state death tax credit. WI ST § 72.01(11m). For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2017 State Death Tax Threshold
		pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. Thereafter, tax imposed only on estates exceeding EGTRRA federal applicable exclusion amount. WI ST §§ 72.01; 72.02, amended in 2001; WI Dept. of Revenue website. On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provided that Wisconsin will not impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident's state of domicile does not impose a death tax. Previously, Wisconsin would impose an estate tax with respect to the intangible personal property of a non-resident decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax.		
Wyoming	None	Tax is tied to federal state death tax credit. WY ST §§ 39-19-103; 39-19-104.		

PART C

Ethical Aspects of Asset Protection

Ethical Aspects of Asset Protection

I. INTRODUCTION

A. Asset protection in some respects has been a part of estate planning for as long as there has been an estate planning discipline. After all, trusts for family members are created in most instances to preserve and protect property for the future use and benefit of the family members. From this perspective, asset protection is really just an integral part of the primary goal of the estate planner—to provide a structure to pass property, either during life or at death, to a client's designated beneficiaries, while reducing transfer taxes and avoiding other costs and delays.

B. In today's increasingly litigious environment, however, asset protection planning is becoming increasingly significant as a separate area of focus within the field of estate planning. The essence of asset protection planning is the use of advanced planning techniques to place assets beyond the reach of future potential creditors.[1] In this way, the client can preserve the assets to pass to his or her family or other beneficiaries through traditional estate planning techniques.

C. Creditor and liability problems can arise from a variety of sources:

1. *Contract Creditors*. Creditor threats can arise from contractual relationships such as consumer debt, bank debt, guaranties, and partnership liabilities.

2. *Tort Creditors*.

a. A tremendous increase in the amount of tort litigation in the United States has occurred in recent years.[2] Moreover, the potential costs to a party found liable may be dangerously severe. In 1999, for example, the top ten jury awards in United States alone totaled $9.6 billion.[3] In addition, annual litigation-related costs in the United States have been estimated at $300 billion.[4]

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[1] Rosen, Howard D. "Asset Protection Planning," Tax Management Portfolio No. 810 (1994), A-1 (hereinafter "Rosen").

[2] See, e.g., Anonymous, "A Rising Tide of Torts?" 71 New York State Bar Journal, April 1999, at 40.

[3] Dana B. Taschner, "The Appeal of Big Jury Awards," Los Angeles Law. (October 2000) 68.

[4] "The Federalist Case for National Tort Reform," Policy Review (Summer 1995), 77.

b. Insurance has often been viewed as a shield against tort judgments. Today, however, individuals with perceived deep pockets, such as doctors, lawyers, and other professionals, may find themselves paying judgments in part out of their own assets, since insurance is no longer adequate to cover many of the judgments which are rendered. Moreover, questions are arising about the stability of the insurance industry in general and the survivability of certain insurance companies in particular.[5]

3. *Regulatory Liability*.

a. Government has imposed liability on various groups to achieve desirable social goals. One of the best examples of this is the liability imposed for the cost of cleaning up environmentally damaged property by the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA" or "Superfund"),[6] as well as other federal and state environmental statutes. CERCLA, for example, gives the Environmental Protection Agency ("EPA") broad powers in the identification and cleanup of contaminated sites and in the recovery of cleanup and related costs from private parties.

b. Subject to certain limited defenses, liability is imposed without regard to fault on any or all of the liable parties. The liability is not necessarily based on the degree to which the party contributed to the problem, if at all. The potential costs to a party on whom liability is imposed are staggering. As of November 27, 2016, there were an estimated 1,337 federal Superfund sites (with an additional 53 proposed sites),[7] and it has been estimated that the average Superfund cleanup costs more than $20 million.[8] Significantly, environmental liability is commonly excluded from general liability policies.

4. *Divorce*. Divorce claims are far more prevalent today than during any previous period. Furthermore, premarital agreements offer only limited protection in the event of divorce. Courts often overturn them if the

[5] For further discussion of this, see Osborne, Duncan, "New Age Estate Planning: Offshore Trusts," 27 University of Miami Institute on Estate Planning Proceedings, ¶ 1700, (1993), (hereinafter "New Age Estate Planning").

[6] 42 U.S.C. §§ 9601-9675.

[7] See www.epa.gov/superfund/sites/, last visited November 27, 2016.

[8] Charles Openchowski, "Superfund in the 106th Congress," 30 Envtl. L. (August 2000) Rep. 10648.

rigorous formalities are not met. Premarital agreements do not cover the various types of interspousal tort claims that can be made, such as the intentional infliction of emotional distress.[9] Finally, many couples, for numerous real or imaginary reasons, fail to enter into them.

5. *Disabled Beneficiaries*. A growing topic of concern for many clients with a disabled parent, spouse, or child is how to create a trust to provide for the needs of that disabled relative, without having the trust assets included among the disabled beneficiary's assets for the purpose of determining whether the beneficiary is eligible for Medicaid or other public assistance.[10]

D. Historically, trusts have been one of the most important, regularly used and accepted asset protection tools available when an individual seeks to make assets available to a third person beneficiary, but wishes to protect those transfers from the beneficiary's creditors. With respect to the transferor's creditors, for reasons set forth below, trusts have until very recently not been viewed as a useful technique for creditor protection.

1. Several developments have changed this environment and have encouraged the use of trusts for protecting assets from the transferor's creditors while, in certain cases, perhaps, retaining for the transferor the use of the transferred assets.

2. Until twenty years ago, the attention had been on Offshore Protection Trusts. While Missouri was the first state to enact Domestic Protection Trust legislation in 1986, few attorneys outside of Missouri paid attention to it or were even aware of it. However Domestic Protection Trusts gained notoriety when, in 1997, both Alaska and Delaware enacted legislation permitting Domestic Protection Trusts. Since then, Michigan, Mississippi, Nevada, Rhode Island, South Dakota, Tennessee, Utah, Wyoming, New Hampshire, Hawaii, Virginia, Ohio, and West Virginia have enacted similar legislation. Colorado may by statute and case law provide asset protection to settlors of irrevocable trusts while Oklahoma provides asset protection to grantors of certain revocable trusts of which the grantor is not a beneficiary but certain family members and charities are.

3. This outline first examines traditional asset protection methods and then reviews Offshore Protection Trusts. The concluding focus of this outline

[9] "New Age Estate Planning," ¶ 1700.2.

[10] A comprehensive overview of this subject is found in Kruse, Clifton, Jr., "Discretionary Trusts: Insulating Discretionary Trust Assets for Elders and Incapacitated Persons from Consideration by Medicaid and Other Public Support Providers," ACTEC Notes, 26 Summer 1991.

is an examination of the Domestic Protection Trusts permitted under the laws of the fourteen states, as well as the possibility of creating perpetual dynasty trusts under the laws of several states that have recently either abolished the rule against perpetuities or allow a trust to opt out of the rule.

4. Of particular concern is whether a settlor who is not a resident of one of the states that allow either perpetual trusts or self-settled asset protection trusts can choose to have a trust governed by the laws of one of those states, and whether a court in a state whose laws have not been so chosen to govern the trust would apply the laws of the chosen state to issues governing trust validity, the validity of transfer of property to the trust, the availability of trust assets to satisfy the settlor's creditors, and to issues relating to perpetuities. This outline therefore examines choice of law provisions and conflict-of-laws principles as they relate to these provisions of trusts.

II. TRADITIONAL ASSET PROTECTION METHODS

A. Outright Gifts of Property. Outright gifts are a simple way for a client to protect his or her assets from the claims of creditors. Assets that the client gives away are no longer subject to seizure by the client's creditors. However, if the client is insolvent, or would become insolvent by making the gift, there may be consequences under the Fraudulent Conveyance statutes, discussed in Part IV of this outline.

1. A transfer of property by gift does not necessarily entail a loss of control or loss of use of the property. There are several ways that a client can indirectly retain benefits from the property.

2. For example, outright gifts between a husband and wife allow the donor spouse to retain indirect control over the property and benefit from the income. In addition, no gift tax will be paid because of the unlimited marital deduction for lifetime transfers between spouses.

EXAMPLE: Husband, a surgeon with substantial exposure to malpractice claims, transfers assets to his spouse, a housewife. The transfers include his interest in their residence, as well as all stocks and bonds. This will protect the assets against the claims of Husband's future creditors, provided that the transfer is not in fraud of creditors. The couple still has unrestricted access to, and use of, the property.

3. Note that the previous example will not always apply when the husband and wife are domiciled, or one or more of the transferred assets are located, in a community property state. Depending on the laws of the particular state, the debtor may be able to reach the husband and wife's community property to satisfy the separate debt of one of them.

4. When outright gifts are not appropriate—such as when the possibility of a divorce is a concern—it often is possible to use trusts to make sure the property is not lost. This is discussed in the following section. Trusts also can be very useful if both spouses are professionals and are equally exposed to malpractice or other claims by creditors.

B. Transfer in Trust.

1. Trusts may be the most important regularly used and accepted asset protection tool available.

2. For transfer of property by gift, a trust can be used to alleviate the client's concerns about the beneficiary's imprudent use of the property. In the case of a transfer to a spouse, a trust will provide some protection in case of later divorce.

   EXAMPLE: Husband, a surgeon with substantial exposure to malpractice claims, wants to transfer assets to Wife, but is concerned about the possibility of a later divorce. Husband transfers $5,000,000 to an irrevocable gift trust for Wife and children (indexed for inflation). Wife is trustee and can distribute property to herself and the children for health and support and to the children for their education. The trust provides that if Husband and Wife divorce, then Wife automatically ceases to be trustee and all her interests in the trust terminate. The gift does not generate gift tax because of Husband's unified credit.

3. Husband also could use a lifetime QTIP trust to transfer property to Wife. The possible drawback of a QTIP trust is that Wife must receive all the income for life, even if there is a divorce. If this is not a concern, however, the QTIP trust can be advantageous, because it is possible to give Husband an interest in the trust if Wife predeceases him.

   a. The marital deduction regulations permit a settlor to create a lifetime QTIP trust in which the settlor has a contingent trust interest if the donee spouse predeceases the settlor. After the donee spouse's death, that spouse will be treated as the transferor of the trust property. See Treas. Reg. §25.2523(f)-1(d) and (f), Examples 9, 10 and 11. Therefore, the original settlor's contingent interest will not be treated as a retained interest under section 2036 of the Code.

   b. For asset protection purposes, the settlor should not actually have a contingent beneficial interest in the trust. This may place the property within the reach of creditors for state law purposes. However, it should be possible to give the donee spouse a testamentary power of appointment that would allow the donee spouse to create a trust for the settlor if the donee spouse dies first.

EXAMPLE: Husband transfers $6,000,000 to a lifetime QTIP trust for wife. Wife has a testamentary power of appointment. If she fails to exercise the power, the trust property will be held in trust at her death for the couple's children. Wife exercises the power in her will to provide that if Husband survives her, the property will be allocated between a marital trust and credit shelter trust for Husband, to make optimal use of the marital deduction and unified credit. The trust property should not be reachable by Husband's creditors, either before or after Wife's death.

4. Of even greater importance is the creditor protection that a trust provides to the trust beneficiaries. In most states, a beneficiary's creditors cannot reach trust assets if the trustee's power to distribute trust assets is subject to the trustee's discretion and the trust has, in good faith, been created by, or the fund so held in trust has proceeded from, a person other than the beneficiary. <u>See</u>, <u>e.g.</u>, 735 ILCS 5/2-1403.

    a. The significance of this potential creditor protection cannot be overstated. For any client who is leaving property to children, the practitioner should discuss the creditor protection benefits of leaving the property in trust for the children's lives.

    b. The trusts can be structured to give each child virtual control over his or her inheritance, while still providing the invaluable benefit of insulation from creditors.

    EXAMPLE: Sam and Molly's aggregate estate will leave about $4,000,000 after taxes for each of their three children at the second death. Each of their children is very responsible and financially sophisticated. The oldest child is a lawyer, the middle child is a physician, and the youngest is a commodities trader. Recognizing the risks involved in each of these professions, Sam and Molly leave the property to the children in trust for their lives. Each child is trustee of his or her own trust. Property may be distributed to the child and his or her descendants for health, education and support. Each child has a broad testamentary power of appointment that allows the child to appoint the trust property to anyone except the child, his or her estate or the creditors of either. Each child's trust should be safe from claims of creditors, but, at the same time, readily accessible by the child for family needs.

    c. Trusts for descendants can provide additional asset protection benefits if the trustee is authorized to purchase assets for the use of the beneficiaries and retain title to those assets in the trust. For example, instead of the trustee making a distribution to a beneficiary to help buy a home or car, the trust could purchase the home or car directly. If the beneficiary is subject to a judgment or

enters bankruptcy, his or her continued use of the home or car will not be affected.

d. In many states, the statutory protection from creditors provided by a trust created by another is automatic. In other cases, the trust agreement must specifically prohibit attachment by, or assignment to, a beneficiary's creditors. Regardless of state law, it is always prudent to include "spendthrift provisions" that prohibit creditors from reaching the trust property. A spendthrift clause may prohibit any voluntary or involuntary (as in bankruptcy) assignment of a beneficiary's interest in the trust. Or, the provision may prohibit only involuntary transfers, but require the consent of the trustee before a beneficiary can voluntarily transfer his or her interest.

SAMPLE LANGUAGE: To the fullest extent permitted by law, (i) no power of appointment or power of withdrawal shall be subject to involuntary exercise, and (ii) no interest of any beneficiary shall be subject to anticipation, to claims for alimony, maintenance, or support, to voluntary transfer without the written consent of the trustee, or to involuntary transfer in any event.

EXAMPLE: One Texas resident was heir to two family fortunes. He received one outright while the other was held for his benefit in a spendthrift trust. He invested the outright fortune in Texas real estate. The Texas real estate market, as it does periodically, collapsed and he went into bankruptcy before the spendthrift trust worth $60 million was to terminate and be distributed to him. The bankruptcy court held that the trust was not subject to creditors' claims because of the spendthrift clause, even though the trust terminated soon after the Texas resident was discharged from bankruptcy. After the dust settled, the Texas resident retained property worth $60 million.

e. A spendthrift provision will be ineffective in most states where the settlor is also a beneficiary of the trust. In general, the settlor's creditors will be able to reach the trust assets to the extent that the trustee could have made permissible distributions to the settlor, whether or not the settlor has the power to compel the distribution. Ariz. Rev. Stat. Ann. § 14-7705(B); Cal. Prob. Code § 15304(b); Mont. Code Ann. § 72-33-305(2). See Altman v. Comm'r, 83 B.R. 35 (D.C. Haw. 1988); In re Morris, 151 B.R. 900 (C.D. Ill. 1993); Coster v. Crookham, 468 N.W.2d 802 (Iowa 1991); Ware v. Golda, 331 Mass. 68, 117 N.E.2d 137 (1954); Vanderbilt Credit Corp. v. Chase Manhattan Bank, 473 N.Y.S.2d 242 (N.Y. App. Div. 1984). But see Mo. Rev. Stat. § 456.080(3)(2) (appearing to limit ability of creditors to reach assets of self-settled trusts). Restatement 2d of Trusts, § 156.

f. The effectiveness of a spendthrift provision will be called into question where the beneficiary has effective control over the trust property, such as when the beneficiary has a power of withdrawal or a Crummey power. Giving the beneficiary a power of withdrawal (or general power of appointment) over the trust property is fundamentally inconsistent with the purpose of a spendthrift trust — to protect the beneficiary from his or her own improvidence. Cal. Prob. Code § 6883. See Matter of Goff, 706 F.2d 574 (5th Cir. 1983); Cooke Trust v. Lord, 41 Haw. 198 (1955); In re McIntosh, 116 B.R. 277 (Bankr. N.D. Okla. 1990); Brent v. State of Maryland Central Collection Unit, 537 A.2d 227 (Md. 1988); Morgan's Estate (No. 1), 223 Pa. 228, 72 A. 498 (1909). Restatement 2d of Trusts § 156.

g. Amendments enacted in 2003 to the trust law in Alaska, however, provide significantly strengthened creditor protection. 2003 Alaska Laws Ch. 138 (H.B. 212). The Alaska law prohibits creditors from attaching trust property before the property is distributed to a beneficiary (including claimants for alimony or child support), and also prohibits a court from ordering a distribution in order to permit a creditor to have access to the property in the hands of the beneficiary. The new law further permits a beneficiary to act as sole trustee of a trust, and the spendthrift provision will still be valid as long as the beneficiary's authority to make a distribution to himself or herself is limited to an ascertainable standard. If the beneficiary is not an Alaska resident, he or she may still be named co-trustee with a qualified Alaska trustee as at least one of the other trustees without limiting creditor protection. Finally, the law extends creditor protection to a beneficiary who holds a lifetime or testamentary general power of appointment over trust property. Most of the other asset protection states have similar legislation.

C. Co-Ownership. Different forms of co-ownership, such tenancy by the entirety, joint tenancy with right of survivorship, and tenancy in common, may provide some protection against creditors.

1. Tenancy by the Entirety.

a. Tenancy by the entirety is a special type of joint tenancy which is only permitted between a husband and wife. Under common law, a tenancy by the entirety was not severable by the husband or wife. In states which follow the common law rule, consequently, the creditor of one spouse cannot seize or obtain a lien on property held in tenancy by the entirety.

b. The protection afforded by a tenancy by the entirety is not permanent. Instead it only lasts as long as both spouses are alive and married to each other.

(1) If the non-debtor spouse dies first, then the debtor spouse will own the property outright, thus subjecting the property to the claims of creditors. (Of course, if the debtor spouse dies first, then the property belongs solely to the non-debtor spouse, thus escaping the claims of creditors).

(2) If the spouses divorce and the property is awarded to the debtor spouse, it will again be subject to creditors' claims.

2. Joint Tenancy With Right of Survivorship. Joint tenancy provides only minimal protection. The creditor of one tenant can reach that tenant's fractional interest at any time during the joint tenancy. The death of the debtor tenant will protect the property only if the creditor has not perfected his or her interest before that tenant's death.

3. Tenancy in Common. A creditor of a co-tenant can reach the debtor's undivided fractional interest, and, since survivorship is not an element of tenancy in common, the death of the debtor tenant will not prevent a creditor from reaching that tenant's interest.

4. Informal Arrangements to Conceal Assets.

a. Some have tried the concealment of assets and variations of "asset return" arrangements, under which a third party agrees to hold title to a debtor's assets until resolution of the problems with the creditors. At that time, the assets will be returned.

b. To be effective, these methods require one or more individuals to commit perjury or other illegal or unethical acts, something an estate planner may never countenance.

D. Exempt Assets.

1. Personal Residence. Separate and apart from the protection of a tenancy by the entirety arrangement, most states have a homestead exemption that allows an individual to always retain a certain amount of equity in their residence. In many states, the exemption is limited; for example, in Illinois, it is $7,500. Florida and Texas, however, have homestead exemptions that allow residents to retain all the equity in their home and adjacent land, subject to certain size (but not value) limitations.

a. Florida allows a homestead exemption for properties of up to 160 acres outside a municipality, and up to one-half acre inside a municipality.

b. Texas has a rural homestead exemption for up to 200 acres for a family, 100 acres for a single person; and an urban homestead exemption for up to one acre.

2. Life Insurance. Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, like Illinois, the exemption is available only if the insurance is payable to a member of the immediate family or other dependent. Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract. Thus, an individual can use an investment-oriented insurance policy as an alternative to transferring property in trust.

EXAMPLE. Stan will be entering into a risky business venture in the near future. He liquidates $1,000,000 of his investment portfolio and invests it in a variable life insurance policy that offers investment of cash value in a selection of mutual funds. Over 15 years, the value of the policy grows to $2,750,000. This property should be exempt from the reach of any future creditors of Stan. After his retirement, Stan could start drawing on the cash value of the policy.

3. Retirement Plans. Both ERISA and the laws of many states protect qualified retirement plans from creditors. Individual retirement accounts are not subject to the ERISA protections, but are protected under the laws of some states, like Texas. One simple asset protection step for a person in a high-risk profession is to take maximum advantage of opportunities to contribute to qualified retirement plans.

4. The use of exempt assets to preserve one's wealth can be extremely effective. In 1988, former Treasury Secretary John Connolly was forced to seek bankruptcy protection. Under Texas law, 200 acres of his ranch, the ranch headquarters, retirement benefits, and life insurance policies were exempt from the claims of creditors. As a result, Connolly exited bankruptcy with a net worth in excess of $3 million. [11]

E. Trusts for Disabled Beneficiaries.

1. The most likely potential creditor of a disabled beneficiary is the federal, state or local agency that provides public assistance to that beneficiary. Over the past 10 to 15 years, public agencies have become more

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[11] Gibbs, Larry W. and Mark A. Schwartzmann, "Tips on International Planning For The U.S. Citizen," 134 Trusts & Estates No. 7, 49 (July 1995) (hereinafter "Gibbs and Schwartzmann").

aggressive in seeking reimbursement for the cost of caring for disabled persons. Many states have passed laws that permit agencies to seek reimbursement and that define the assets which are available to the government agency. These statutes must be considered carefully when drafting a trust that is designed to provide supplemental benefits to a disabled person in order to improve the quality of the person's life without having the entire trust subject to confiscation by a government agency.

2. State case law is not consistent in defining the standard of distribution that will cause trust assets to be chargeable for a disabled beneficiary's care. In many states, a trust that allows the trustee to make distributions for the "support and maintenance" of a beneficiary will be treated as an asset of the beneficiary for the purpose of determining eligibility for public aid. However, in other cases, a state has been unable to obtain reimbursement for public aid where the trust instrument allowed the trustee to use principal for the beneficiary's support and maintenance, (especially in cases in which the trust instrument evidenced the testator's intent that trust assets merely supplement support from other sources). Many state legislatures are now attempting to provide statutory guidelines for when trust assets will be considered available to the beneficiary for the purpose of qualifying the beneficiary for public assistance or allowing the state to seek reimbursement from trust assets.

III. SOPHISTICATED TECHNIQUES FOR ASSET PROTECTION

A. Limited Partnerships.

1. The family owned partnership has become a popular vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. The family partnership provides a number of benefits, both tax and non-tax, including valuation discounts, transfers of value without relinquishing control, and restrictions on further transfer of limited partnership interests.

2. With respect to asset protection planning, a limited partner's personal exposure for the debts of the partnership is generally limited to his investment in the partnership. This prevents a creditor of the partnership from reaching the personal assets of a limited partner to satisfy debts owed by the partnership.

3. A limited partnership also can provide a modest level of creditor protection against creditors of a partner who are seeking assets to satisfy a debt or judgment. Almost every state has enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"). RULPA helps protect a limited partnership interest from the claims of creditors of the partner by mandating an unattractive remedy for a creditor seeking that partner's interest.

4. Usually, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. Section 703 of RULPA provides that a court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. Under Section 702 of RULPA, the assignee judgment creditor is only entitled to receive those distributions to which the debtor partner would have been entitled, unless there is a contrary provision in the partnership agreement. The effect of the charging order is that a partner's creditor will only receive those partnership distributions which, absent the charging order, would have been distributed to the debtor partner.

5. The family can build on the unsatisfactory nature of the charging order remedy by including provisions in the partnership agreement that trigger purchase options in the other partners when one partner's interest becomes subject to a charging order or that partner declares bankruptcy. Typically, the purchase options are at a deep discount from the net asset value of the partnership interest. This allows the partnership to take the creditor out of the picture entirely, while preserving the underlying partnership assets to the maximum extent possible. Of course, this leaves the debtor family member without an interest in the partnership. However, because the family has been able to preserve a greater share of the partnership property, other family members may be able to restore part of the debtor's interest through gifts after the creditor problems have passed.

6. The tax treatment of a charging order also may discourage a creditor from going after a limited partnership interest. Many tax practitioners believe that the income tax effect of a creditor obtaining a charging order is to cause the creditor to become liable for that partnership interest's share of the partnership income, even if no distributions actually are made by the partnership. See Rev. Rul. 77-137, 1977-1 C.B. 178 (assignee of limited partner's entire interest is taxed on distributive share of partnership income even if not a substituted limited partner).

    a. Some commentators have questioned whether a creditor with a charging order can be equated with an assignee of an entire partnership interest. Local law may determine how the holder of the charging order is to be treated for tax purposes.

    b. In family partnership situations in states in which the law is not clear, the general partner could take the position that the charging order does burden the creditor with a share of the taxes, in order to encourage the creditor to accept a minimal amount in satisfaction of the debt.

B. Attacks on Charging Order as Sole Remedy.

1. Some commentators have argued that the charging order remedy is appropriate only in nonfamily situations because in family situations, every partner is presumably aware of each other's financial situation and therefore the other partners should not be entitled to the protection that a charging order affords.[12]

2. In two California cases, courts provided authority that a creditor could foreclose upon an interest in a limited partnership, thereby causing its sale.

   a. In Crocker National Bank v. Perroton, 208 Cal. App. 3d 311, 255 Cal. Rptr. 794 (Cal. App. 1st Dist. 1989), the court permitted the sale of a limited partnership interest to satisfy the claim of a judgment creditor. The court based its opinion on California Corporations Code § 15028(1), which provides that the court "may ... make all other orders, directions, and inquiries which the circumstances of the case may require" and refers to a possible court ordered sale of a partnership interest which is subject to a charging order. However, the facts in the case indicate that it may be of limited use to a creditor because the other partners consented to the sale of the limited partnership interest. (In a family partnership situation, this is unlikely to happen, absent bad blood among the family members.)

   b. A similar but more far-reaching result was reached in Hellman v. Anderson, 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (Cal. App. 3d Dist. 1991), which involved the sale of a general partnership interest. The Hellman court emphasized that the consent of the nondebtor partners did not necessarily have to be obtained in every case in which a forced sale was sought. However, it added that before authorizing the foreclosure of a charged partnership interest, the trial court must determine that a foreclosure of the charged partnership interest will not unduly interfere with partnership business.

3. In one Connecticut case, Madison Hills Limited Partnership II v. Madison Hills, Inc., 644 A.2d 363 (Conn. App. 1994), the court went one step further than the courts in Hellman and Crocker. The court held that under the UPA, a charging creditor may enforce its charging order not only through a forced sale but also through "strict foreclosure" (i.e., the vesting of title of the partnership interest absolutely in the charging creditor, on default in payment, without any sale of the property).

[12] Id.

4. In addition to the possibility of a state court ordering the foreclosure of a partnership interest by a charging creditor, some commentators point out that it may be possible to obtain a federal bankruptcy order to sell a partnership interest (though not to sell an underlying partnership asset, unless the creditor's claim was secured by such asset).[13]

   a. In In re Smith, 185 B.R. 285 (Bankr. S.D. Ill. 1995), the court held that a bankruptcy trustee assumed all the rights of the bankrupt limited partner, and therefore could maintain a suit to dissolve the partnership on the grounds that it was not carrying on a business.

   b. Courts are divided as to whether the filing of a bankruptcy proceeding by or against a general partner of a partnership automatically causes a dissolution of the partnership. Compare Phillips v. First City, Texas - Tyler, 966 F.2d 926 (Cal. App. 5 1992) (recognition of a Chapter 11 bankruptcy estate as a general partner in a limited partnership creates an untenable conflict of interest requiring dissolution of the partnership) with In re Safren, 65 B.R. 566, 14 BCD 1261, 16 CBC 2d 315 (BC CD Cal. 1986) (filing of a Chapter 11 case by or against a partnership does not dissolve the partnership).

5. The message to estate planners from these cases is that, depending on the specific facts of a case, courts may no longer view charging orders as the sole remedy available with respect to the limited partnership interest of a debtor. This also means that, in drafting limited partnership agreements, the draftsperson should take all steps necessary to ensure that a creditor of a partner will not have a detrimental impact on the partnership, including providing the following in the partnership agreement:

   a. Transfer restrictions on general and limited partnership interests;

   b. A requirement that all partners, general and limited, consent to a dissolution before the stated term;

   c. Successor general partners and the conversion of a withdrawing general partner's interest to a limited partnership interest;

   d. A requirement that the general partner must consent to the admission of any assignee as a limited partner;

   e. A mechanism for the removal of the general partner in cases of default or insolvency; and

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[13] Id.

f. Mechanisms to continue the partnership with remaining general partners or successor general partners in the case of an event of dissolution (e.g., death, bankruptcy or incapacity of a general partner).

C. Limited Liability Companies.

1. The limited liability company ("LLC") is a viable alternative to the use of a limited partnership. The LLC first became available in Wyoming in 1977 and is now available in every state. The LLC has the limited liability of a corporation, but preserves the flow through treatment of taxable income (or loss) of a partnership. The LLC can provide an attractive alternative to the use of a general or limited partnership, especially where there is a desire to limit the personal liability of the family members in relation to the activities of the entity.

2. With respect to asset protection issues, many state LLC statutes contain charging order sections similar to that found in the RULPA. Also, LLC statutes generally contain the following types of provisions which provide protection quite similar to the protection afforded by a limited partnership:

a. A member's interest in an LLC is personal property and is not an interest in specific assets of the LLC;

b. An assignee will not become a member of the LLC without the unanimous consent of the other members; and

c. An assignee who is not a member is only entitled to receive the share of profits and income to which the assignor is entitled and has no right to participate in the management of the LLC.[14]

D. Offshore Protection Trusts.

1. Offshore Protection Trusts have become one of the most talked about estate planning techniques in recent years. They are heavily promoted as effective barriers against claims of creditors because the laws of most offshore trust havens make it difficult for creditors to obtain jurisdiction over, or levy against, a trust, even if the settlor retains an interest in the trust property. Unlike most states of the United States, a number of foreign jurisdictions permit a settlor to create a spendthrift trust for his or her own benefit. These barriers often insulate the property entirely from creditors, or produce early and inexpensive settlements.

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[14] Rosen, supra, p. A-9.

2. Creditor Protection Benefits.

   a. An Offshore Protection Trust can create geographic, legal, procedural, and financial hurdles to reaching its assets.

   b. The mere fact that a trust is a foreign trust may deter creditors from pursuing the trust. This is particularly likely if the trust is funded with assets from the foreign jurisdiction. The cost of pursuing a claim against a foreign trust can be high, especially since foreign jurisdictions may prohibit contingent fee litigation or require significant deposits to commence a proceeding.

   c. Some jurisdictions, such as the Cook Islands, do not recognize foreign judgments.[15] Thus, an action first brought in a United States court may have to be tried all over in a foreign jurisdiction.

   d. As mentioned, many foreign jurisdictions have favorable spendthrift trust provisions which protect the interests of a settlor-beneficiary. Such provisions are in contrast to dominant rule in the United States that one may not create a spendthrift trust for one's own benefit.

3. Other Advantages. In addition to the creditor protection benefits of an Offshore Protection Trust, such a trust may offer an individual the following other advantages:

   a. Economic diversification;

   b. Achievement of a "low profile" or anonymity with respect to wealth;

   c. Premarital and marital planning;

   d. Preparing for the contingency of changing one's citizenship;

   e. Participation in investments not otherwise available to U.S. investors;

   f. Planning in anticipation of currency controls or fluctuations; and

   g. Liability protection, tax planning, or strategic advantage with respect to an active trade or business.[16]

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[15] International Trusts Act of 1984, § 13D (1996) (Cook Islands).

4. Popularity. Offshore Protection Trusts are now quite popular among wealthy families, investment managers and professionals, such as doctors, lawyers, and accountants, as ways to shield their assets from malpractice claims. Estimates indicate that $1 trillion worth of assets are held in Offshore Protection Trusts.[17] However, there is no estimate as to how much of this total consists of U.S. source assets.

5. Provisions of Offshore Protection Trusts.

   a. The basic provisions of an Offshore Protection Trust generally include the following:

      (1) *Governing Law*. The trust is created and governed under the laws of one of several foreign jurisdictions that have laws favorable to Offshore Protection Trusts. These include among others: (i) the Cook Islands; (ii) the Cayman Islands; (iii) Gibraltar; (iv) the Isle of Man; (v) the Bahamas; (vi) Belize; (vii) the Turk and Caicos Islands; (viii) Cyprus; and (ix) Nevis.

      (2) *Irrevocability*. The trust is irrevocable; however, as described below, there is usually a substantial power of amendment vested in a third party.

      (3) *Term*. The trust may have a term for a set number of years or last for the life of the settlor or one or more beneficiaries.

      (4) *Beneficiaries*. The beneficiaries normally include the settlor and one or more family members.

      (5) *Trustees*. A trustee located in the jurisdiction is almost always required. Typically, this is a foreign corporation with trust powers. It may be possible to have one or more U.S. co-trustees, but this increases the risk of attachment by creditors since a U.S. trustee is potentially within the jurisdiction of U.S. courts.

      (6) *Distributions*. A foreign trustee usually has unfettered and absolute discretion over the distribution of income and principal.

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[16] Osborne, Duncan D., Asset Protection: Domestic & International Law and Tactics, §19.03 (1996) (hereinafter "Asset Protection").

[17] Marty-Nelson, Elena, "Offshore Asset Protection Trusts: Having Your Cake and Eating It Too," 47 Rutgers Law Review 11 (Fall 1994).

(7) *Control*.

(A) The settlor often retains some degree of control over the trust through: (i) Membership in or designation of a committee of advisors, with powers similar to those of a "trust protector," described below; (ii) Retaining limited authority to take steps such as removing trustees and appointing new trustees; or (iii) Designating a "trust protector" with authority to make more substantial changes to the trust, such as moving the trust to another jurisdiction, or terminating a beneficiary's interests. Some experts recommend that the trust protector be unrelated to the settlor and his or her family. One commentator, for example, reports that a member of his firm serves as the trust protector for the first years of the trust. This, according to the commentator, insures proper record-keeping and U.S. tax reporting during the formative years of the trust and also provides time to train a successor.[18]

(B) Typically, the degree of control that a settlor retains bears an inverse relationship to the amount of creditor protection that the trust provides. In other words, the more control that a settlor is willing to relinquish, the greater asset protection he or she generally will achieve. Conversely, if a settlor retains too much control, he or she runs the risk of having the entire arrangement overturned by a court as a "sham transaction."[19]

b. Additional provisions are frequently included in Offshore Protection Trusts in order to increase their effectiveness against potential creditors. These include the following:

(1) *Ability of Foreign Trustee or Other Fiduciary to Change Situs of Trust Assets*. The trustee or trust protector can be given the power to change the situs of the trust assets to another jurisdiction which can be employed if an action is threatened against the trust in its original jurisdiction. This

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[18] Larry W. Gibbs & Mark Schwartzmann, "Tips on International Planning for the U.S. Citizen," 134 Trusts & Estates, July 1995, at 37, 38.

[19] Asset Protection, §§ 20:08-20:09.

increases the costs to the creditor of making its claim and, consequently, acts as a deterrent to any such claim.

(2) *Letter of Wishes*. The settlor of the trust can provide non-binding written guidelines to the trustee. These cover the settlor's intent with respect to the investment of the assets and the making of distributions to family members. The guidelines can be changed as circumstances or the desires of the settlor change.

(3) *Duress Clause*. A duress clause directs a foreign trustee to ignore the advice, order, or instruction of a U.S. trustee if such advice, order, or instruction is given under "duress," which should be defined in the trust instrument to include court compulsion.

(4) *No Benefits Term*. The trust might include a provision that provides for a term during which the beneficiaries are solely persons other than the trust settlor. This term may correspond with the limitations period applicable to claims of creditors in the foreign jurisdiction governing the trust.

(5) *Restrictions on Beneficial Interests*. The trust can provide that the settlor is only one of several permissible beneficiaries with the trustee having the power to choose among them and to remove one or more of them. The trust can also provide that upon the happening of a certain event (e.g., a judgment against the settlor), the settlor's beneficial interest in the trust (and any fiduciary powers held by the settlor) either may be terminated or held in abeyance for a specified period of time.

6. Confidentiality.

a. Early in the planning stages for an Offshore Protection Trust, confidentiality should be stressed to the potential settlor and all related parties. Although information regarding the trust may not be protected from the IRS or trust beneficiaries, it can in many cases be hidden from third parties who might later become creditors.

b. The planner should strive for confidentiality with respect to the trust's existence, its terms and provisions, its value and the nature of its assets, the location of the trust's assets, the trustees and, if applicable, trust protector's identity and activities, the settlor's and

beneficiaries' identity, and the nature, name, and role of any ancillary entities associated with the trust.[20]

7. Funding of Offshore Protection Trusts.

a. Situs of the Assets.

(1) One method of funding an Offshore Protection Trust is to transfer interests in a U.S. family limited partnership or other domestic legal entity. The idea is that while the underlying asset is physically situated in the United States, the foreign trust law has been imported to protect the interests. Although it may be possible to "export" the underlying assets at a later time, there is a risk with this approach that a U.S. court will freeze the assets before they can be moved.[21]

(2) A second method of funding an Offshore Protection Trust is to use assets that are located in the trust's governing foreign jurisdiction. If the assets are located in the trust's jurisdiction, a claimant or creditor pursuing those assets typically will have to do so in that jurisdiction. When total jurisdictional severance is desired, it is important to select a foreign initial or successor trustee that has no nexus with the United States (that is, a trustee that does not have a United States subsidiary or is not itself a subsidiary of a U.S. corporation).[22]

(3) A third method of funding is to use assets that are located in a jurisdiction other than the trust situs or the United States. Locating the assets in a third jurisdiction adds a layer of complexity to the entire structure which may be either helpful or harmful to the interests of creditor protection, depending on the laws of each jurisdiction.[23]

b. How Much Should be Placed in the Offshore Protection Trust?

(1) Some commentators argue for placing as much of the client's assets as possible in a U.S. family limited

[20] Id., § 20:10.

[21] Id., § 20:04.

[22] Id.

[23] Id., § 20.08.

partnership, and putting 99% of the limited partnership interests into an offshore trust. This technique combines the protection afforded by partnerships with the protection afforded by offshore trusts. The intent would be that once a possible claim surfaced, the foreign trustee would have the power under the trust agreement to remove the domestic trustee (to protect them from any potential court order) and, as majority limited partner, to liquidate the partnership and move the assets offshore to protect against creditors.[24]

(2) Other commentators argue for placing only a limited percentage in an Offshore Protection Trust and using assets that are physically located in the foreign jurisdiction to fund the trust. Such an approach, especially if coupled with well-documented reasons other than, or in addition to, asset protection, arguably is less likely to give rise to allegations of a fraudulent conveyance than placing all of one's assets in the Offshore Protection Trust because, when a limited percentage of the total assets is used, the client could pass a solvency test after the creation and funding of the offshore trust.[25]

(3) Although an Offshore Protection Trust may be funded with any amount of assets, typically it should be funded with at least $1 million of assets to justify the expenses of creating and administering the trust.

8. Income and Transfer Tax Implications of Offshore Protection Trusts.

a. Income Tax Neutrality. Normally, Offshore Protection Trusts are designed to be income tax neutral, with the income being taxed to the settlor under the grantor trust rules. Internal Revenue Code section 679 mandates this treatment in most cases. Internal Revenue Code section 679 applies when:

(1) The grantor is a United States citizen or resident alien;

(2) The grantor makes a transfer to the foreign trust; and

(3) The trust has a United States beneficiary.

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[24] Rothschild, Gibson, "Asset Preservation: Legal and Ethical Strategies." New York Law Journal, 1 (March 11, 1994).

[25] "New Age Estate Planning," ¶ 1703.8.

b. Potential Consequences on Funding.

(1) Until 1997, the Internal Revenue Code contained a detailed excise tax under section 1491, which imposed a 35% excise tax on the unrealized appreciation on property transferred by a United States person to a foreign entity, including a foreign trust. This provision was rarely applicable to Offshore Protection Trusts because they are almost always grantor trusts under the Code. At the settlor's death, the trust ceased being a grantor trust and, in Revenue Ruling 87-61, 1987 C.B. 219, the Service ruled that the excise tax would apply at that time; this would rarely be a problem with a section 1014 basis step-up.

(2) The Taxpayer Relief Act of 1997 repealed section 1491 and replaced it with new section 684, effective August 5, 1997. Section 684 imposes an immediate recognition of gain on transfers of property by a United States person to, inter alia, a foreign estate or trust. Subparagraph (b) excludes from this recognition treatment a transfer to a trust created as a grantor trust with respect to the settlor.

c. Changes Made by the Small Business Job Protection Act of 1996. The Small Business Job Protection Act of 1996 made several changes to the rules governing the income taxation of foreign trusts. These changes amended the rules for determining whether a foreign trust is a grantor or non-grantor trust, increased reporting requirements on foreign trusts, stiffened penalties for failure to report, and generally reduced the opportunities for U.S. persons to use such trusts to avoid or delay current taxation of income. Transfer Tax Implications of the Creation and Funding of an Offshore Protection Trust. Private Letter Ruling 9332006 (August 20, 1992) describes a situation in which assets in an Offshore Protection Trust were excluded from a settlor's estate. The trust was to hold limited partnership interests and was to be established under the laws of County X. It was determined that the property would not be included in the settlor's estate under section 2033, since under the law of County X, the gifts to the trust would be complete and the settlor would have no right to compel distributions from the trust. The IRS ruled that sections 2036 and 2038 would not apply, because the settlor had retained no interest in the trust and the transfers were completed gifts. However, in many instances, the settlor does not wish to incur gift tax at the time an Offshore Protection Trust is funded, and transfer tax

objectives are secondary.[26] In fact, it is often generally assumed that the assets in the Offshore Protection Trust will be taxable in the settlor's estate.

9. Selecting a Particular Foreign Jurisdiction.

a. In selecting a foreign jurisdiction for an offshore trust, it is important to find a jurisdiction with a favorable, well-defined, and protective trust law and fraudulent disposition law. Provisions such as the following are desirable:

(1) Self-settlement (e.g., the allowance for a settlor to be the trustee or beneficiary of a trust);

(2) Short limitations period for a creditor to bring a fraudulent disposition claim;

(3) High burden and standard of proof on creditors who are making a fraudulent disposition claim;

(4) Lengthy perpetuities period;

(5) Redomiciliation (e.g., the ability for the trustee to change the situs and governing law of a trust pursuant to the terms of the trust instrument, if necessary);

(6) Protection against forced dispositions, including forced dispositions based on the laws of another jurisdiction;

(7) Allowance of broad powers for trustees and trust protectors;

(8) Local court jurisdiction over local trusts;

(9) Reasonable or no local registration requirements;

(10) Allowance for a transferor to retain a beneficial interest in and a degree of control over the Offshore Protection Trust without exposing the trust to the transferor's creditors;

(11) Minimal or no requirements regarding the settlor's solvency following transfers to the trust; and

(12) Substantial barriers to the freezing of trust assets.[27]

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[26] This is discussed further in Gibbs and Schwartzmann, supra, 40.

b. Aside from the nature of a jurisdiction's protective trust and fraudulent disposition law, the following factors should be considered in selecting a particular foreign jurisdiction:

(1) Political, economic, and social stability;

(2) Reputation in world business community;

(3) Tax laws;

(4) Language barriers;

(5) Communications facilities; and

(6) Adequate legal, accounting, and financial services, which become particularly important if the Offshore Protection Trust is funded with assets located in the foreign jurisdiction.[28]

c. Location is Fact Specific. There is no right or wrong location. Instead, each attorney must look at the particular client's situation to determine which is the right location.[29] In some cases, the existence of aggressive trust and fraudulent conveyance legislation in a jurisdiction will bear more importance than the jurisdiction's qualities as a financial center. In other cases, the reverse will be true.

10. Cost of Establishing an Offshore Protection Trust. The creation and maintenance of an Offshore Protection trust can be quite expensive. Typically, the settlor will have to engage a U.S. accountant, U.S. attorney, foreign attorney, and foreign trustee. In some cases, the settlor may also have to engage a trust protector, an investment advisor, and a foreign custodian banker. In addition, the settlor should be prepared to pay some local taxes and registration charges and a variety of fees. In sum, the initial cost of implementing an Offshore Protection Trust may range from $5,000-$10,000 at the low end to in excess of $100,000 in the high end,

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[27] Some of these are discussed in Engel, Barry S., "Using Foreign Situs Trusts for Asset Protection Planning," 20 Estate Planning, No. 4., 214 (July/August 1993), (hereinafter "Engel").

[28] Engel, supra, 214.

[29] For a detailed discussion of the features of the laws of the different jurisdictions which are favorable to Offshore Protection Trusts, see Asset Protection, §§ 27-40, and Rosen, supra, A–31.

and there will be annual maintenance costs on top of the cost of initial creation.[30]

11. Offshore Trust Subject to Claims of Creditors.

a. Taxpayers who have established offshore trusts are beginning to discover that they do not always provide the level of creditor protection advertised. The fundamental problem is that a U.S. resident who moves assets to an offshore trust is still personally subject to the jurisdiction of U.S. courts. As in a recent Florida bankruptcy case, In re Lawrence,[31] the court may have little sympathy for someone who has, in its view, "stashed" funds offshore.

b. On January 8, 1991, Stephen Lawrence established an offshore trust in Jersey (in the Channel Islands) with an initial contribution of $7 million. This trust was established two months prior to the conclusion of a 42 month arbitration dispute with Bear Stearns and Company that resulted in a $20.4 million award in favor of Bear Stearns. On February 7, 1991, the trust was amended to add specific spendthrift language and to move the property to Mauritius. On January 23, 1993, the trust was amended so that the settlor's powers could not be exercised under duress or coercion and that Lawrence's life interest would terminate in the event that Lawrence became bankrupt.

c. Lawrence subsequently declared bankruptcy. On August 26, 1999, the bankruptcy court ordered Lawrence to turn over the trust assets to satisfy partially a judgment obtained by Bear Stearns. On September 8, 1999, the bankruptcy court held Lawrence in contempt for failing to turn over the assets, and ordered him to be jailed. The court said that because the trust was his own creation, the debtor could not avail himself of the impossibility defense. The court also stated that it tortured reason and abandoned common sense that Lawrence would transfer $7 million to a trust and release all control. Lawrence appealed to the district court.

d. The district court supported the bankruptcy's court's conclusion that Lawrence set up the trust for his own benefit. Moreover, it found that Lawrence effectively had dominion over the property in the trust and that the spendthrift provisions were not enforceable as a shield against creditors. It found that Lawrence's attempt to use

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[30] Asset Protection, supra, § 19:08.

[31] 251 B.R. 630 (S.D. Fla., July 31, 2000).

an offshore trust contravened the clear public policy against allowing a debtor to shield money placed in a trust for his or her own benefit from creditors, defied common sense, and was undermined by language in the trust that gave Lawrence the power to remove and appoint trustees.

e. Upon review, the district court found that the order of incarceration for Lawrence should be upheld. The district court cited the Ninth Circuit's holding in Federal Trade Commission v. Affordable Media, LLC.[32] Affordable Media involved an attempt by a couple, the Andersons, to hide money in an offshore trust based in the Cook Islands. Under the terms of that trust, if an event of duress occurred, the Andersons were removed as co-trustees and the Cook Island trustee was prohibited from repatriating assets. In a contempt proceeding at the District Court level, the Andersons had argued that they could not comply with the court order to repatriate the assets because to do so was impossible. The District Court was not impressed and held the Andersons in contempt. The Ninth Circuit upheld the contempt finding. In 2006, Lawrence was released from prison when the court determined that the contempt penalty was no longer capable of having the desired coercive effect.

f. Lawrence and Affordable Media do not spell the end of offshore asset protection trusts or the domestic protection trusts currently available. However, they do reveal some limitations. The Andersons and Lawrence appear to have been involved in fraudulent schemes. U.S. law generally voids transfer if they are in fraud of actual or foreseeable creditors. Courts are inclined to retain this approach with offshore asset protection trusts even if local law governing the trust is different. Moreover, both the Andersons and Lawrence appear to have retained too much control. In the case of the Andersons, they acted as both trustees and trust protectors for their trust. Lawrence had the power to remove and appoint the trustee. Both the Andersons and Lawrence failed to follow the general rule that the less the amount of control retained, the greater the protection afforded by an asset protection trust.

g. In United States v. Grant, Case No. 00-08986-CIV-Jordan (S.D. Fl. 2008), the court declined to impose the contempt penalty on one of the grantors for the failure to repatriate assets from an offshore asset protection trust.

[32] 179 F.3d 1228 (9th Cir. 1999).

Mr. and Mrs. Grant established offshore trusts in Jersey and Bermuda. The Federal Government sought to recover millions of dollars in back taxes owned by Mr. and Mrs. Grant. In 2003, a final judgment in the amount of $36,280,939.43 was entered. To help pay the back taxes, the government obtained an order for repatriation of the assets held in the Jersey and Bermuda trusts. Subsequently, Mr. Grant passed away.

The court's opinion was that "significant" efforts were made by Mrs. Grant to repatriate the funds to the United States. Less than one month after the issuance of the repatriation order, Mrs. Grant sent a letter to the trustee in Jersey enclosing the repatriation order and seeking information about the procedure to repatriate funds. The lawyers for the Jersey trustee replied that any petition for repatriation of the funds would be futile. Mrs. Grant also contacted the trustee for the Bermuda trust and met with a similar response. Likewise Mrs. Grant sent letters to various financial institutions asking them to serve as transferee trustees. These institutions declined because of the potential legal fees that would be incurred in terms of defending the IRS and requesting a full accounting from prior trustees.

The government argued that Mrs. Grant failed to comply with the repatriation order. While recognizing that more than two years had elapsed since the issuance of the repatriation order, the court found that the failure was not for lack of effort on Mrs. Grant's part. The court felt that Mrs. Grant sufficiently established her inability to repatriate the offshore funds and therefore denied the government's motion that she be held in contempt

12. A Final Word of Caution.

a. A client should not expect that an Offshore Protection Trust will provide perfect protection against the claims of creditors. If the creditor has a skilled lawyer, the existence of the foreign trust usually will become known.

b. A litigious and determined creditor can make life very difficult for a debtor who has offshore assets and refuses to settle in some manner with the creditor. The creditor, for example, can force the debtor into involuntary bankruptcy, and convince the court to refuse to discharge the debtor until he or she gives up some of the assets in the offshore trust.

c. As related by a colleague, this apparently happened to a Texas man who had an offshore trust. The judge kept the man in bankruptcy and ordered that he obtain court approval for any expenditure he

planned to make, including, for example, buying groceries, so the court could determine the source of the funds and whether any portion could be given to the creditor.

d. Moreover, there is at least some concern that the local courts will interpret their laws narrowly to minimize the possibility of their jurisdiction being viewed as a rogue country vis-à-vis the international community.

IV. FRAUDULENT CONVEYANCES

A. The most effective means for a creditor to attack an asset protection plan is use of the fraudulent conveyance laws. Fraudulent conveyance provisions exist under both the federal Bankruptcy Code and state law. Most states have adopted a version of the Uniform Voidable Transactions Act (formerly known as the Uniform Fraudulent Transfer Act) ("UVTA"). These provisions must be considered any time one engages in any asset protection planning that involves transferring property to a third person, including the trustee of an Offshore Protection Trust.

B. Fraudulent Conveyances as to Existing Creditors. Under the UVTA, a transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if:

1. The debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation;[33] or

2. The transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.[34]

C. Fraudulent Conveyances as to Future Creditors.

1. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose after the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation:

a. with *the actual intent* to hinder, delay or defraud any creditor of the debtor;[35] or

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[33] UVTA § 5(a).

[34] UVTA § 5(b).

[35] UVTA § 4(a)(1).

b. without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor:

(1) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business of transaction; or

(2) intended to incur, or believed or reasonably should have believed that he would incur debts beyond his ability to pay as they became due.[36]

2. Although the UVTA does not distinguish between different classes of future creditors, courts have created a distinction between future creditors that the debtor can reasonably foresee and those that the debtor cannot reasonably foresee. Under this distinction, actual intent to defraud can exist as to the former but not as to the latter. For example, in Hulbert v. Shackleton,[37] a Florida court held that a physician who transferred assets to his wife after his insurance policy was canceled did not have actual intent to defraud one of his existing patients because the patient was not a reasonably foreseeable creditor at the time of the transfer. As a result, individuals without pending or threatened claims against them, and who otherwise do not "intend to embark on some course of conduct or to proceed with [their] affairs with reckless regard for the rights of others" can legitimately proceed with asset protection planning, including the creation of Offshore Protection Trusts.[38]

D. Determination of Actual Intent - Badges of Fraud. In determining whether a debtor had actual intent to defraud creditors and therefore made a fraudulent conveyance as to foreseeable future creditors, the so-called "badges of fraud" are to be assessed. The badges of fraud, with respect to a transfer, include:

1. The transfer was to an insider (e.g., a relative of the debtor[39] or a corporation in which the debtor is the person in control[40]);

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[36] UVTA § 4(a)(2).

[37] 560 So.2d 1276 (Fla. 1st Dist. 1990)

[38] Engel, Barry S., "Sole Purpose Asset Protection Planning." 28 Offshore Investment Journal Investments 50 (July/August 1992).

[39] UVTA § 1(8)(A).

[40] UVTA § 1(8)(D).

2. The debtor retained possession or control of the property transferred after the transfer;

3. The transfer was not disclosed or was concealed;

4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

5. The transfer was of substantially all the debtor's assets;

6. The debtor absconded;

7. The debtor removed or concealed assets;

8. The value of the consideration received by the debtor was not reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

9. The debtor was insolvent or became insolvent shortly after the transfer was made;

10. The transfer occurred shortly before or shortly after a substantial debt was incurred; and

11. The debtor transferred the essential assets of the business to a lien or who transferred the assets to an insider of the debtor.[41]

E. Solvency. The debtor's solvency before and after a transfer is probably the most important factor in determining whether the transfer was fraudulent. Usually, absent actual intent to defraud, a transfer is not considered fraudulent if, following a transfer, the debtor retained sufficient non-exempt assets to satisfy the claims of creditors. It is for this reason that a transfer of all of one's assets to an offshore trust or other asset protection devise runs a high risk of being ineffective.

F. Remedies.

1. In an action brought under the UVTA, a creditor may obtain any of the following remedies:[42]

a. Setting aside of the transfer to the extent necessary to satisfy the creditor's claim;

b. Attachment of the transferred asset or other property of the transferee;

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[41] UVTA § 4(b).

[42] UVTA § 7.

c. An injunction against further disposition by the debtor or a transferee, or both, of the asset transferred or of other property;

d. The appointment of a receiver to take charge of the transferred asset or other property of the transferee; or

e. Any other relief the circumstances may require.

2. Under the Federal Bankruptcy Code, it is also possible under certain circumstances for a creditor to have a debtor's transfer voided if the creditor files a petition with the Federal bankruptcy court within one year of the transfer.[43]

G. Reducing the Risk of a Fraudulent Conveyance Attack. Some of the concerns with respect to avoiding a fraudulent conveyance attack against the creation and funding of an Offshore Protection Trust can be overcome if one can show legitimate reasons for the creation of the trust other than to prevent creditors' claims. In order to be able to demonstrate legitimate reasons for the creation of an Offshore Protection Trust and therefore to avoid the impact of the UVTA, an attorney should consider having the client provide an affidavit indicating the reasons for the transfer, stating the client's financial condition, and indicating the client's ability, after the transfer, to pay reasonably anticipated debts as they come due.

V. EXPATRIATION

A. Tax-Motivated Expatriation. Many individuals and families are considering renouncing their United States citizenship and moving to a foreign jurisdiction to avoid what they perceive to be the confiscatory nature of the United States' income and transfer tax systems.

1. For example, Michael Dengman, Chairman of Abex and a director of Ford, is now a Bahamian citizen and lives there. Billionaire John Dorrance III, an heir to the Campbell Soup fortune, is now a citizen of Ireland and lives there as well as in the Bahamas and Wyoming. Kenneth Dart, an heir to the Dart Container's family fortune of $1 billion, is a citizen of Belize and works in the Cayman Islands.[44]

2. The number of expatriating families is growing significantly. In 1981, President Reagan lowered taxes. The following year, not a single American gave up his citizenship. In 1993, President Clinton raised taxes. Three hundred and six Americans renounced their citizenship and left the

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[43] 11 USCA § 548(a).

[44] Tenzer, Robert and Phillippe Mao, "The New Refugees," Forbes, November 21, 1994, p. 31.

country that year.[45] The number of Americans expatriating can only be expected to grow in the future years, absent some unlikely fundamental change in the American income and transfer tax systems.

B. The Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Legislation").

1. The HEART Legislation, which President Bush signed on June 17, 2008, has possible income, gift, and estate tax consequences for United States citizen who expatriate and fall within the definition of a "Covered Expatriate." A covered expatriate is a United States citizen who expatriates and who at the time of expatriation has a net worth of at least $2 million or has had an average annual net income for the five years prior to expatriation of greater than $139,000. The legislation exempts two types of U.S. Citizens who expatriate from these rules. The first is individuals who became dual citizens at birth. The second are children who expatriate before attaining the age of 18½ years. Expatriation only occurs when the individual renounces his or her U.S. citizenship or the State Department otherwise approves the loss of U.S. citizenship.

2. The HEART Legislation, which was effective June 18, 2008, subjects covered expatriates to essentially an exit tax on the net unrealized gain in appreciated property by stating that any appreciated property is deemed sold on the day before expatriation to the extent that the gain exceeds $600,000. The same rules apply to appreciated property held in any grantor trust of which the covered expatriate is deemed to be the owner. Covered expatriates are also deemed to receive a distribution of their entire tax exempt retirement accounts and IRAs on the day before expatriation. However, no early distribution penalty tax applies to the deemed distribution of tax exempt retirement accounts and IRAs. The property owned by a covered expatriate that is subject to the expatriation tax receives a step up in basis. There are also provisions that permit a covered expatriate to defer payment of the exit tax on appreciated property until actual sale. In order for this exception to apply, security satisfactory to the Internal Revenue Service must be provided.

3. The HEART Legislation also enacts a new Section 2801 that applies to "covered gifts" and "covered bequests" made by covered expatriates. The covered gifts and bequests are property acquired directly or indirectly from a covered expatriate by a United States recipient. The tax is equal to the highest estate or gift tax at the time of the receipt of the gift or the bequest. Interestingly, the rules apply not only to U.S. property, but also to foreign property. A charitable and marital deduction is provided for covered gifts and bequests. The U.S. recipient of the gift or bequest has to

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[45] Id.

pay the tax unless the covered expatriate files a gift tax return or an estate tax return.

VI. ETHICAL AND OTHER CONSIDERATIONS FOR ATTORNEYS

A. Threshold Question.

1. Is counseling clients regarding asset protection planning (and assisting clients in the creation of asset protection vehicles) ethical? Obviously, there is no single correct answer, and each situation must be assessed separately with regard to federal and state ethical rules.

   a. The primary sources of federal rules are the American Bar Association's Model Code of Professional Responsibility (the "Model Code") and Model Rules of Professional Conduct (the "Model Rules"). The primary sources of state rules are each state's code of professional conduct.

   b. These sources do not expressly address asset protection planning, but they require an attorney to represent a client within the boundaries of the law and to carry out the representation without conduct involving fraud or deceit.[46]

2. Generally, as long as a lawyer is counseling a client about asset protection activity that is not fraudulent or otherwise unlawful, the lawyer can take comfort that he or she is remaining within the ethical rules. However, the realities are often far murkier.

   a. First, a lawyer may not in every case have sufficient facts from a client to know whether a client's asset protection activity is fraudulent or otherwise unlawful.

   b. Second, even when the lawyer has all the facts, the line between lawfully advising a client about the legality of an activity and furthering an illegal activity is not always clear.

3. An attorney counseling or participating in a fraudulent transfer may face professional discipline and may be liable to a client's creditors.

B. Ethical Obligations.

1. Under the Model Rules, a lawyer "may discuss the legal consequences of any proposed course of conduct with the client, and may counsel or assist the client to make a good faith effort to determine the validity, scope,

[46] See, e.g., Model Code DR 1-102; Model Rule 1.2.

meaning, or application of the law."[47] An attorney crosses the ethical line when he begins counseling or assisting in conduct that he knows is criminal or fraudulent.[48]

2. In the context of asset protection planning, one state bar suggests that a lawyer would face discipline for participating in a transfer that he "knows is either intended to deceive creditors or that has no substantial purpose other than to delay or burden creditors."[49]

    a. A transfer intended to deceive creditors may be easily recognizable, but a transfer that has no substantial purpose other than to delay or burden creditors may be more difficult to discern. In Connecticut, an attorney was assisting a client who had substantial debts he was unable to pay. The attorney asked the Bar Association whether he could ethically recommend that the client transfer his interest in his home to his wife. The attorney sought to draft the deed, and he planned to have it executed and filed without giving notice. He also asked whether the transaction was deceptive, considering that the deed to the home was a public record.

    b. The Connecticut Bar Association clarified that even if the attorney does not have a purpose to deceive, this transaction is intended to "throw up a roadblock or to discourage creditors from trying to use the property to satisfy a debt."[50] If there is no other purpose for the transfer, this transaction does not comport with Model Rule 4.4, which states that a lawyer shall not use means that have no substantial purpose other than to . . . delay or burden a third person.[51]

    c. In discussing this issue, the Bar Association's opinion also stated that a "demonstrable and lawful estate planning purpose" would satisfy the substantial purpose requirement and demonstrate that the client is not solely trying to delay or burden creditors.[52]

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[47] Model Rule 1.2 (d).

[48] Id.

[49] Connecticut Bar Association *Informal Opinion* 91-22 at 1 (Dec. 5, 1991).

[50] Id. at 5.

[51] Model Rule 4.4.

[52] Id. at 7.

3. Whether or not a transfer is fraudulent as a matter of law is not the decisive factor under the rules. In Oregon, an attorney who knowingly assisted his client in transferring assets to avoid creditors was guilty of an ethical violation, despite the fact that the court did not find any tortious fraudulent conveyance.[53] The attorney was suspended for his involvement in the transfer.

4. According to the Model Rules, the decisive factor regarding liability in asset protection situations is the lawyer's knowledge that the transfer is intended to deceive or thwart creditors.[54] There are numerous examples of attorneys who have knowingly participated in deceptive transfers. An attorney in South Carolina who assisted a client with a conveyance of property designed to frustrate creditors was guilty of misconduct and suspended for 15 months.[55] In California, an attorney was suspended for three years because he transferred a client's real property after learning of a decision in a case that was adverse to his client.[56]

    a. Because knowledge is central to the ethical standards, it is important to consider how much information an attorney must obtain from the client. The lawyer does not have an independent duty to investigate the nuisances of the client's intent in each transaction, he but must obtain all the information from the client that is necessary to provide competent advice.[57]

    b. The Connecticut State Bar explicitly said that if the lawyer has obtained all of the information necessary to effectuate the representation and the lawyer is still uncertain about whether the transaction is intended to deceive or has no substantial purpose, "the lawyer is entitled, if not obligated, to give the client the benefit of the doubt."[58]

5. Generally, protecting assets from potential future creditors is permissible, but conveying assets to avoid "existing and identifiable" creditors is an

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[53] In re Hockett, 734 P.2d 877 (Or. 1987).

[54] Connecticut Bar Association *Informal Opinion* 91-23.

[55] In re Kenyon & Lusk, 491 S.E.2d 252 (S.C. 1997).

[56] Townsend v. State Bar of California, 197 P.2d 326 (Cal. 1948).

[57] Connecticut Bar Association *Informal Opinion* 91-23.

[58] Id. at 6.

ethical violation.[59] For example, in South Carolina an attorney proposed to assist a client in transferring property to his spouse for the sole purpose of preventing the possibility of a future creditor recovering against the property. The South Carolina Bar Ethics Advisory Committee held that the proposed transfer was permissible "as long as there [was] no immediate reasonable prospect of a judgment being entered against the client."[60] However, some creditor's rights advocates claim that a transfer is fraudulent and unethical if the purpose of the transfer was to hinder, delay, or defraud creditors, even if a creditor's claim had not arisen at the time of the transfer.[61]

C. Personal Liability for Assisting Clients in Defrauding Creditors.

1. Generally, an attorney is not responsible for the consequences of his client's actions.[62] However, attorneys may not be insulated from liability if they are furthering or participating in a fraudulent conveyance.

a. Civil Conspiracy

(1) Some states permit an attorney and client to be sued under a theory of civil conspiracy for participating in an alleged fraudulent conveyance. A civil conspiracy is an agreement to commit an unlawful act which causes damage to a person or property.

(2) An Arizona court found that an attorney engaged in a conspiracy when he attempted to hinder and fraudulently delay the creditor from collecting a judgment.[63] The court concluded that the judgment creditor had a valid claim for damages, and it required the attorney to pay the lesser of the amount transferred or the value of the debt.

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[59] ABA/BNA Lawyer's Manuel on Professional Conduct, 1001:1801, American Bar Association and The Bureau of National Affairs, Inc. (1991-1995); See Townsend, 197 P.2d at 326.

[60] South Carolina Ethical Advisory Committee, Opinion 84-02 (May 25, 1984).

[61] Rosen, Howard D. & Rothschild, Gideon, "Asset Protection Planning," Tax Management Portfolio No. 810 2nd (2002), A-7 (hereinafter "Rosen & Rothschild").

[62] Pickard v. Maritime, 161 So.2d 239, 241 (Fla. App. 1964).

[63] McElhanon v. Ling, 728 P.2d 256 (Ariz. App. 1986), aff'd in part and vacated in part, 728 P.2d 273 (Ariz. 1986), cert. denied 481 U.S. 1030 (1987).

(3) Conversely, a court in Illinois found that an attorney was not liable for conspiracy because there was no evidence that the attorney counseled the debtor to defraud the lender or agreed to participate in any fraud.[64]

(4) Some courts do not allow a general creditor to bring a claim for conspiracy, and other courts have dismissed conspiracy charges by holding that a fraudulent transfer is not a tort, meaning that the elements of conspiracy could not be established.[65]

b. Aiding and Abetting

(1) In a few states, a creditor may also bring a claim against an attorney for aiding and abetting in a fraudulent transfer. This claim alleges that the attorney knowingly gave "substantial assistance" to someone who performed wrongful conduct.[66] This claim rarely succeeds because of the difficulty of proving damages and the uncertainty as to whether a tort of aiding and abetting even exists.[67]

(2) Some jurisdictions have completely rejected aiding and abetting charges against an attorney. The Supreme Court of Florida recently held that there was no cause of action for aiding and abetting a fraudulent transfer so long as the person aiding was not a transferee.[68]

c. Domestic Asset Protection Statutes

(1) In the last sixteen years, fourteen states have adopted Domestic Asset Protection Statutes containing provisions to shield professionals, such as lawyers, accountants and financial advisors, who assist with asset transfers in the United States.[69] These statutes explicitly state that a

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[64] Bosak v. McDonough, 549 N.E.2d 643 (Ill. App. 1989).

[65] Rosen & Rothschild supra, p. A-10. In an action for conspiracy, there must be damages arising out of the tortious acts planned in the conspiracy.

[66] Id. at A-11.

[67] Id.

[68] Lewis B. Freedman, etc v. First Union National Bank, 865 So.2d 1272 (Fla. 2004).

[69] Shaftel, David G., "Domestic Asset Protection Trusts: Key Issues and Answers," 30 ACTEC Journal 30 (2004).

creditor may not bring a conspiracy or aiding and abetting claim against the professional.[70]

(2) But, these statutes cannot completely protect a professional, because only a few states have enacted them. If a creditor is prevented by statute from bringing an action in its state, it could still attempt to bring an action in the state where the client resides.[71]

D. Potential Liability for Failing to Counsel Asset Protection Planning.

1. The Model Rules require a lawyer to act with "commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf."[72] An attorney is liable for malpractice when he fails to exercise the care, skill and diligence that would be exercised by an attorney practicing in a similar situation.[73] A malpractice claim differs from the claims previously discussed because the attorney is being held liable to his own client, as opposed to creditors or a professional disciplinary body.[74] Because an attorney who specializes in a particular area of law will be held to a higher standard of care, attorneys assisting in asset protection planning may receive a higher degree of scrutiny in malpractice claims.[75]

2. Some commentators have suggested that a malpractice claim may arise if an attorney fails to suggest some forms of asset protection planning. One writer has given the example of a wealthy client who consults with his attorney regarding a comprehensive estate plan. During the course of his analysis, the attorney is made aware that the client has a significant securities portfolio, which the lawyer recommends be transferred to the revocable trust he is drafting for the client. Three years after the estate plan is implemented, the client is sued for a matter which arose two years after he met with the estate planner. The client suffers a financially catastrophic judgment and is required to liquidate his revocable trust in

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[70] E.g., Alaska Stat. §34.40.110(e) (2003); Del. Code tit. 12 § 3572(d) (2003).

[71] Sfaftel supra p.30.

[72] Model Rule 1.3.

[73] Rosen & Rothschild supra, p. A-12.

[74] Id.

[75] Id.

order to satisfy the claim. The client then sues the attorney for failing to discuss asset protection with him.[76]

3. As this example demonstrates, counseling clients in asset protection is essential and, to properly serve clients, an attorney must not only explain the procedure involved but must also clearly communicate the ambiguities and risks of the client's choices.

E. Minimizing Liability.

1. Considering the ethical rules and the potential for civil liability, a lawyer should exercise due diligence to "accurately characterize and evaluate the client's circumstances and motivation."[77] This should include learning the client's source of wealth, reasons for seeking assistance with asset protection, and any current issues with creditors.

2. An attorney should also conduct a solvency analysis, and obtain from the potential client a statement in which the client affirms that the client has no pending claims, will remain solvent and able to pay anticipated debts following the transfer, and is not seeking to transfer any assets earned from unlawful activities. [78]

VII. ABOLITION OF THE RULE AGAINST PERPETUITIES

A. The common law Rule Against Perpetuities (the "Rule") provides that no interest is good unless it vests or fails within a life in being plus twenty-one years.[79] Currently, twenty states effectively have abolished the Rule. Nine states have repealed the Rule outright. A tenth (Delaware) has repealed the Rule with respect to interests in personal property. An additional nine states and the District of Columbia have preserved the Rule, but have granted trust settlors the authority to opt out of it by including specified provisions in their trust instruments. In 2000 Florida extended the perpetuities period to 360 years,[80] and in 2001 Washington

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[76] Rosen, supra, p. 3.

[77] Ballson, Kathryn A., "Attorney Liability and Ethics," Vol. 1, No. 2 West Group Rel. 5/98 (A.P.D.)§ 4:10.

[78] Rosen & Rothschild, supra, p. A-13.

[79] See Angela M. Vallario, Death by a Thousand Cuts: The Rule Against Perpetuities, 25 J. Legis. 141 & n.1 (1999) (citing John Chipman Gray, The Rule Against Perpetuities 191 (4th ed. 1942)).

[80] Florida Stat. Ann. § 689.225(2)(f). This provision is valid for all trusts created after December 31, 2000. For older trusts, the previous perpetuities period of 90 years remains effective.

extended it to 150 years.[81] In 2003, Utah extended its perpetuities period to 1,000 years.[82] Also, in 2003, Wyoming adopted an opt-out provision for personal property and extended the perpetuities period to 1,000 years.[83] In 2005, Nevada extended the perpetuities period to 365 years.[84] In 2006, Colorado extended the perpetuities period to 1000 years.[85] In 2007, Tennessee extended the perpetuities period to 360 years.[86]

B. Repeal Legislation. Statutory provisions in Alaska, Idaho, Kentucky, New Jersey, Rhode Island, South Dakota, and Wisconsin each provide that the Rule is not in force in the respective states, while Pennsylvania provides for this for interests created after December 31, 2006.[87] Statutes in effect in Idaho, South Dakota, and Wisconsin provide that the repeal of the Rule applies retroactively.[88] By contrast,

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[81] Wash. Rev. Code § 11.98.130. This provision is applicable to any irrevocable trust with an effective date on or after January 1, 2002. Unless the trust instrument otherwise provides, this provision does not apply to any irrevocable trust with an earlier effective date or any revocable or testamentary trust with an effective date on or after January 1, 2002 if at all times after the date of enactment the creator of the trust was not competent to revoke, amend or modify the will or trust instrument.

[82] Utah Statutes § 75.2-1203.

[83] Wy. ST. § 34-1-3-139(b).

[84] Nev. Rev. Statutes § 111.031.

[85] Col. Rev. Statutes § 15-11-1102.5 (1).

[86] Tenn. Code § 66-1-202 (f).

[87] See Alaska Stat. §34.27.075 (West 2000) ("The common law rule against perpetuities does not apply in this state"); Idaho Code §55-111 (West 2000) ("there shall be no rule against perpetuities applicable to real or personal property"); Kentucky Rev. Stat, ch. 381, § 224 ("An interest created in real or personal property shall not be void by reason of any rule against perpetuities, whether the common law rule or otherwise. The common law rule against perpetuities shall not be in force in this Commonwealth); N.J. Stat. Ann. § 46:2F-9 (West 2000) ("No interest created in real or personal property shall be void by reason of any rule against perpetuities, whether the common law rule or otherwise. The common law rule against perpetuities shall not be in force in this State"); R.I. Gen. Laws § 34-11-38 (West 2000) ("The common law rule against perpetuities shall no longer be deemed in force and/or of any effect in this state"); S.D. Codified Laws § 43-5-8 (West 2000) ("The common-law rule against perpetuities is not in force in this state"); Wis. Stat. Ann. §700.16(5) (West 2000) ("The common-law rule against perpetuities is not in force in this state"). Pennsylvania Senate Bill 660 (signed on July 7, 2006), amending Pennsylvania Consolidated Statutes Title 20, § 6104.

[88] Idaho's statute provides that "no trust heretofore or hereafter created, either testamentary or inter vivos, shall be declared void [under the Rule]. . ." Idaho Code §55-111. South Dakota's statute provides: "If no action or proceeding has been instituted by July 1, 1984, to declare void

New Jersey's statute provides that it shall not be applied retroactively.[89] It is unclear whether the repeal of the Rule in Alaska or Rhode Island applies retroactively[90]. North Carolina repealed the Rule Against Perpetuities effective August 9, 2007.[91] A state constitutional problem arose because of the provision of Section 34 of Article I of the North Carolina Constitution that provides "Perpetuities and monopolies are against the genius of a free state and shall not be allowed." On February 2, 2010, the North Carolina Appellate Court upheld the constitutionality of the North Carolina repeal.[92] Hawaii repealed the Rule with respect to its form of domestic asset protection trust that became effective July 1, 2010.[93]

C. Delaware and Michigan Partial Repeal Legislation. Delaware has repealed the Rule only with respect to interests in personal property,[94] but replaced the

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any instrument which existed prior to July 1, 1983 under the provisions of this chapter as it existed prior to July 1, 1983, then all such instruments shall be interpreted under this chapter 43-5." S.D. Codified Laws §43-5-9. Wisconsin's statute provides that it "applies to interests in property in existence on July 1, 1971, and to interests in property created after such date." Wis. Stat. Ann. §700.25.

[89] New Jersey's statute provides that the abolishment legislation applies to future property interests or powers of appointment created on or after 7/9/99 or created before 7/9/99 pursuant to the laws of a state that does not enforce the Rule and to which, after 7/9/99, New Jersey law is made applicable by such means as a transfer of the trust situs to New Jersey or a change in the law governing a trust instrument to New Jersey law. See N.J. Stat. Ann. §46:2F-11(a).

[90] Alaska's statute provides that the statutory rule against perpetuities contained in Alaska Statutes §34.27.051 applies to trust instruments executed on or after April 2, 1997 if the trust instrument creates a nonvested property interest subject to the exercise of a power of appointment that creates a new or successive power of appointment. See Alaska Stat. §34.27.070. Neither §34.27.051 nor §37.27.070 discusses nonvested property interests that are not subject to such powers of appointment. Therefore, it appears to be unclear whether the repeal of the Rule applies retroactively to all nonvested property interests. Rhode Island's statute provides that the Rule is no longer in force provided that "the provisions of this section shall not be construed to invalidate or modify the terms of any interest which would have been valid prior to the effective date of this act [1999]. . ." R.I. Gen. Laws §34-11-38.

[91] N.C. Gen. Stat. §41-23.

[92] Brown Brothers Harriman Trust v. Benson, 202 N.C. App. 283 (2010), appeals denied by North Carolina Supreme Court, 703 S.E. 2d 157 (2010).

[93] Hawaii Rev. Stat. §525-4(6).

[94] See Del. Code Ann. tit. 25, §503(a) (West 2000) ("No interest created in real property held in trust shall be void by reason of the common law rule against perpetuities and no interest

common law Rule with a perpetuities period of 110 years for real property held in trust.[95] It is unclear whether either of these provisions apply retroactively to existing trusts. Michigan has repealed the Rule with respect to personal property effective May 28, 2008.[96]

D. Opt-Out Legislation. The remaining twelve states (plus the District of Columbia) that have effectively abolished the Rule have done so by providing settlors with the power to opt out of the Rule's application to their trusts. These states include Illinois, Maine, Maryland, Ohio, Arizona, Colorado, Missouri, New Hampshire, Virginia, and Wyoming.

1. *Illinois Opt-Out Legislation*. Illinois' opt-out statute preserves the common law Rule.[97] However, the statute provides that the Rule shall not apply to "qualified perpetual trusts."[98] A "qualified perpetual trust" is defined as any trust created by any written instrument executed on or after January 1, 1998, including an amendment to an instrument in existence prior to that date and the exercise of a power of appointment granted by an instrument executed or amended on or after that date:

a. to which, by the specific terms governing the trust, the Rule does not apply; and

b. the power of the trustee (or other person to whom the power is properly granted or delegated) to sell trust property extends beyond the period of the Rule.[99]

2. *Maine, Maryland and New Hampshire Opt-Out Legislation*. The opt-out legislation of Maine, Maryland and New Hampshire is very similar to that of Illinois. Maine, Maryland and New Hampshire preserve the Rule but provide specific opt-out provisions.[100] While Maine's and New

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created in personal property held in trust shall be void by reason of any rule against perpetuities, whether the common law rule or otherwise").

[95] See id. at §503(b).

[96] Mich. Comp. Laws §§ 554.91-94.

[97] See 765 Ill. Comp. Stat. Ann. 305/2 (West 2000) (common law Rule shall remain in full force and effect, except as modified by statutes in force by 9/22/69).

[98] See id. at 305/4(a)(8).

[99] See id. at 305/3(a-5).

[100] See Me. Rev. Stat. Ann. tit. 33, §§101, 101-A (West 2000); Md. Code Ann., Est. & Trusts §§11-102, 11-102(e) (West 2000), N.H. Rev. Stat. § 547-3-K.

Hampshire's opt-out provisions apply prospectively,[101] it is unclear whether Maryland's opt-out provisions apply prospectively or retrospectively. The statutes of these three states provide that the Rule does not apply to a trust where:

a. the governing instrument states that the Rule does not apply to the trust; and

b. the trustee (or other person to whom the power is properly granted or delegated) has the power to sell, mortgage, or lease property beyond the period of the Rule.[102]

3. *Ohio Opt-Out Legislation*. Ohio also preserves the Rule,[103] but many of its opt-out provisions, which apply prospectively,[104] differ from those in place in Illinois, Maine, and Maryland. In order to trigger the opt-out provisions in Ohio, the trust instrument must specifically state that the Rule shall not apply to the trust and either the trustee must have an unlimited power to sell all trust assets or one or more persons, one of whom may be the trustee, must have the unlimited power to terminate the entire trust.[105] In addition, one or more of the following conditions must be satisfied:[106]

a. The trust is executed in Ohio;

b. The sole trustee or one of the trustees is domiciled in Ohio;

c. The trust is administered in Ohio or the situs of a substantial portion of the assets subject to the testamentary portion of the trust is in Ohio, even though some part or all of those assets are physically deposited for safekeeping in a state other than Ohio; or

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[101] See Me. Rev. Stat. Ann. tit. 33, §101-A (exemptions from the Rule apply to trusts created after 1999); N.H. Rev. Stat. § 547-3-K (statute applies to any disposition created after December 31, 2003).

[102] See Me. Rev. Stat. Ann. tit. 33, §101-A; Md. Code Ann., Est. & Trusts §11-102(e).

[103] See Ohio Rev. Code Ann. §2131.08(A) (West 2000).

[104] See id. at §2131.09(B)(3) (opt-out provisions apply to an interest in property in trust created either by wills of decedents dying on or after 3/22/99, by a trust instrument executed on or after 3/22/99, or by the exercise of a general power of appointment on or after 3/22/99).

[105] See id. at §2131.09(B)(1).

[106] See id. at §2131.09(B)(2).

d. The instrument creating the trust states that Ohio law is to apply.

4. *Arizona Opt-Out Legislation*. Arizona's opt-out statute also preserves the Rule, but validates a nonvested property interest in trust that meets specified criteria.[107] The Arizona statute does not require the trust instrument to state specifically that the Rule does not apply, but rather validates any nonvested property interest under a trust whose trustee has the expressed or implied power to sell the trust assets and at one or more times after the creation of the interest one or more persons who are living when the trust is created have an unlimited power to terminate the interest.[108] Arizona's statute does not apply retroactively to existing trusts.[109]

5. *Missouri Opt-Out Legislation*. Missouri's opt-out statute provides that the Rule not apply to a trust if the trustee, or other person or persons to whom the power is delegated, has the power pursuant to the terms of the trust or applicable law to sell the trust property during the period during which the trust continues beyond the period of the rule of perpetuities that would otherwise apply to the trust.[110] The opt-out statute is applicable to (i) trusts created by a will or inter vivos agreement, or pursuant to the exercise of a nongeneral power of appointment granted under a will or inter vivos agreement, executed or amended on or after August 28, 2001, (ii) trusts created pursuant to the exercise of a general power of appointment exercised in an instrument executed or amended on or after August 28, 2001, or (iii) any such trust created before August 28, 2001, if the laws of Missouri become applicable to the trust after such date and under the laws of the state applicable to the trust prior to such date the trust was not subject to the rule against perpetuities.[111]

6. *Virginia Opt-Out Legislation*. Virginia's recent opt-out statute provides that the Rule shall not apply to interests in personal property held in a trust if the trust instrument, by its terms, provides that the Rule shall not apply

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[107] See Ariz. Rev. Stat. Ann. §14-2901(A) (West 2000).

[108] See id. at 14-2901(A)(3).

[109] See id. at 14-2905(A) (opt-out provisions apply to nonvested property interests created on or after 12/31/94).

[110] Mo. Ann. Stat. § 456.236(1) (Vernon 2001). Any rule prohibiting unreasonable restraints on or suspension of the power of alienation is also not violated by such a trust. Id.

[111] Mo. Stat. Ann. § 456.236(3) (Vernon 2001).

to such trust.[112] It is not clear whether the opt-out provision is retroactive.[113]

7. *Wyoming Opt-Out Legislation*. Wyoming's opt-out statute provides that for trusts created after July 1, 2003, the Rule shall not apply if:

   a. the trust instrument states that the Rule does not apply;

   b. the trust instrument states that the trust shall terminate no later than 1,000 years after its creation; and

   c. the trust is governed by the laws of Wyoming and the trustee has a place of business in Wyoming, administers the trust in Wyoming, or is a resident of Wyoming.[114]

The opt-out election is not available for real property held in the trust.[115]

E. Income Tax Considerations.

1. In selecting a state in which to establish a perpetuities-free trust, one should also consider the extent to which the income of the trust will be subject to state income tax.

2. Three of the perpetuities-free states, Alaska, Nevada, and South Dakota, do not have an income tax. In addition, Ohio does not tax the income of trusts.

3. Although all, or nearly all, states that have an income tax will tax trust income that is derived from sources within that state, typically from real estate or business conducted within the state, most will tax the remaining trust income (and thus treat the trust as a "resident trust") only if certain conditions are met, which vary dramatically from state to state. Such conditions may include the residence of the grantor when a trust becomes irrevocable (Illinois, Missouri, New Jersey, Wisconsin), the place where

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[112] Va. Code Ann. §55-13.3(C) ("The rule against perpetuities shall not apply to any trust or any interest created in personal property held in such trust, or to any power of appointment over personal property held in such trust, or to any power of appointment over personal property granted under such trust, when the trust instrument, by its terms, provides that the rule against perpetuities shall not apply to such trust.").

[113] See J. Rodney Johnson, Wills, Trusts, and Estates, 34 U. Rich. L. Rev. 1069, 1069 (2000), for a discussion of the Virginia opt-out legislation.

[114] Wy. ST. §34-1-139(b).

[115] Wy. ST. §34-1-139(c).

the trust is administered (Colorado, Maine, Maryland, Virginia), or the residence of one or more fiduciaries (Delaware, Rhode Island). Even if the trust meets the requirements for taxation within a state, some (Delaware, Rhode Island) will exclude from taxation any income attributable to a non-resident beneficiary.

F. Summary. The following tables summarize the provisions, including the factors that make trust resident for income tax purposes, of those states which have effectively abolished the Rule Against Perpetuities. The state income tax provisions for determining the residence of a trust are often more complex than can be summarized in this table, and these provisions should be examined carefully before selecting a state based on its taxation of trust income.

REPEAL JURISDICTIONS

State	Perpetuities Provision	State Income Taxation of Trust (Factors that cause income to be taxed in the state, regardless of the source of the income)	Treats Real Property and Personal Property Differently?
Alaska	Complete repeal of common law Rule.	None	No
Delaware	Complete repeal of common law Rule, but creation of 110 year perpetuities period for trust holding real property	(i) Created by resident; (ii) Sole trustee is resident or has office in state; (iii) Corporate trustee has office in state; (iv) All trustees are individuals and at least half are residents; No tax on income allocable to nonresident beneficiaries	Yes
Idaho	Complete repeal of common law Rule. Applies retroactively to existing trusts.	Income of trust is taxed if at least three of the following: Resident grantor Trust created in state Trust property in state Resident trustees Administration is state	No
Kentucky	Complete repeal of common law rule	Fiduciaries must pay income tax on the portion of the income from an estate or trust that is not distributable to beneficiaries	No
Michigan	Repeal of common law Rule with respect to personal property, effective May 28, 2008	Income taxed unless trustees, beneficiaries, and administration are outside Michigan	Yes

State	Perpetuities Provision	State Income Taxation of Trust (Factors that cause income to be taxed in the state, regardless of the source of the income)	Treats Real Property and Personal Property Differently?
New Jersey	Complete repeal of common law Rule. Does not apply retroactively.	Grantor of trust or portion of trust resident at time trust became irrevocable	No
North Carolina	Complete repeal of common law Rule. Applies retroactively to existing trusts.	Taxes North Carolina source income and income from sources outside North Carolina which is for the benefit of a North Carolina resident	
Pennsylvania	Complete repeal of common law rule, effective January 1, 2007. Repeal does not apply to trusts created before January 1, 2007.	Grantor of trust or portion of trust resident at time trust becomes irrevocable	No
Rhode Island	Complete repeal of common law Rule.	Revocable trust that becomes irrevocable upon any event (including death) that terminates a resident's power to revoke; or Irrevocable trust created by resident, but only while creator continues as resident or after death if a resident at death. No tax on income allocable to nonresident beneficiaries	No
South Dakota	Complete repeal of common law Rule. Applies retroactively to existing trusts.	None	No
Wisconsin	Complete repeal of common law Rule. Applies retroactively to existing trusts.	Grantor of trust or portion of trust resident at time trust became irrevocable	No

EXTENSION JURISDICTIONS

State	Perpetuities Provision	State Income Taxation of Trust (Factors that cause income to be taxed in the state, regardless of the source of the income)	Treats Personal Property and Real Property Differently?
Colorado	Rule extended for 1,000 years	Trust administered in Colorado	No
Florida	Rule extended for 360 years	None (but can have intangibles tax)	No
Nevada	Rule extended for 365 years	None	No
Tennessee	Rule extended for 360 years	Yes	No
Utah	Rule extended for 1,000 years	Utah taxes the income of (i) a trust, or portion of a trust, consisting of property transferred by will of a decedent who was domiciled in Utah at death, and (ii) a trust that is administered in Utah. A trust is administered in Utah if (i) the place where the fiduciary transacts a major portion of its administration of the trust is in Utah, or (ii) the usual place of business of the fiduciary is in Utah.	No
Washington State	Rule extended for 150 years.	None	No
Wyoming[116]	Rule extended for 1,000 years	None	Yes

[116] Wyoming is an opt-out jurisdiction. The 1000 year perpetuities period only applies if a decision is made to opt out of the rule.

EXCEPTION JURISDICTION

State	Perpetuities Provision	State Income Taxation of Trust (Factors that cause income to be taxed in the state, regardless of the source of the income)	Treats Personal Property and Real Property Differently?
Hawaii	Rule repealed for Hawaii domestic asset protection trusts	Hawaii applies a 1.0 % excise tax on the fair market value of all assets transferred to a Hawaiian Asset Protection Trust. Any income or capital gains accumulated for the benefit of non-resident beneficiaries is excluded from Hawaiian income tax.	Trust cannot hold real estate

OPT-OUT JURISDICTIONS

State	Perpetuities Provision	State Income Taxation of Trust (Factors that cause income to be taxed in the state, regardless of the source of the income)	Treats Real Property and Personal Property Differently?
Arizona	Preserves Rule, but validates nonvested property interest under trust (i) whose trustee has power to sell trust assets; and (ii) at one or more times after creation of the interest one or more persons living when trust is created have unlimited power to terminate interest. Opt-out provision does not apply retroactively.	All fiduciaries are resident; or All beneficiaries are resident; or If beneficiaries and settlor are nonresident, and some, but not all fiduciaries are resident, non-Arizona source income taxed in proportion to number of resident fiduciaries; or If fiduciary(ies) and settlor are nonresident, and some, but not all beneficiaries are resident, non-Arizona source income taxed in proportion to interest of resident beneficiaries;	No
District of Columbia	Preserves Rule, but provides exception for a trust in which the governing instrument states that "the provisions of this chapter do not apply to the trust and under which the trustee, or other person to whom the power is properly granted or delegated, has the power under the governing instrument, applicable statute, or common law to hold, sell, lease, or mortgage property for any period of time beyond the period that is required for an interest created under the governing instrument to vest."	Grantor of trust resident at time trust became irrevocable	No

State	Perpetuities Provision	State Income Taxation of Trust (Factors that cause income to be taxed in the state, regardless of the source of the income)	Treats Real Property and Personal Property Differently?
Illinois	Preserves common law Rule, but provides exception for "qualified perpetual trusts." A "qualified perpetual trust" is a trust (i) created by written instrument executed on or after 1/1/98 (including amendment to existing trust and exercise of power of appointment granted by existing trust); (ii) to which, by specific terms governing trust, Rule does not apply; and (iii) power of trustee (or other qualified person) to sell trust property extends beyond period of Rule. Opt-out provision does not apply retroactively.	Grantor of trust resident at time trust became irrevocable	No
Maine	Preserves Rule, but provides exception for trust if (i) trust instrument states Rule does not apply; and (ii) trustee (or other qualified person) has power to sell, mortgage, or lease trust property beyond the period of the Rule. Opt-out provision does not apply retroactively.	Irrevocable trust created by resident at time of funding; or Revocable trust during period when settlor is resident; or The trust is registered with Probate Court	No
Maryland	Preserves Rule, but provides exception for trust if (i) trust instrument states Rule does not apply; and (ii) trustee (or other qualified person) has power to sell, mortgage, or lease trust property beyond the period of the Rule.	Grantor is a current resident; or Trust is principally administered in the state	No
Missouri	Preserves Rule, but provides exception for trust created after 8/28/01 if the trustee or a delegatee has the power to sell trust property after the period of the Rule that would otherwise apply.	Grantor resident in Missouri at time trust becomes irrevocable and at least one income beneficiary resident in Missouri on last day of tax year	No

New Hampshire	Preserves Rule, but provides exception for trusts created after December 31, 2003 (i) if instrument expressly exempts trust from the Rule and (ii) trustee has power to sell mortgage or lease property for period beyond the Rule.	None, but intangibles tax applies to trusts for New Hampshire beneficiaries	No
Ohio	Preserves Rule, but provides exception for trust if: (i) trust is created after 3/22/99; (ii) trust instrument states that Rule does not apply; (iii) trustee has unlimited power to sell all trust assets or one or more persons (one of whom may be trustee) have unlimited power to terminate entire trust; and (iv) trust is executed in Ohio, a trustee is domiciled in Ohio, the trust is administered in Ohio or situs of substantial portion of assets subject to testamentary portion of trust is in Ohio, or trust instrument states that Ohio law is to apply. Opt-out provision does not apply retroactively.	Ohio taxes the income of a testamentary trust created by an Ohio resident and an intervivos trust created by an Ohio resident if there is a beneficiary resident in Ohio.	No
Virginia	Preserves Rule, but provides exception for interests created in personal property held in trust if trust instrument states that Rule does not apply.	Trust created by resident; Trust administered by resident; Trust under supervision of Virginia court.	Yes
Wyoming	Preserves Rule but provides exception up to 1,000 years for trusts created in personal property after July 1, 2003 if trust states that Rule does not apply.	None	Yes

VIII. DOMESTIC PROTECTION TRUSTS

A. Missouri Domestic Protection Trusts.

1. In 1986, Missouri amended its spendthrift statute to become the first state to permit settlors of trusts to obtain spendthrift protection if the transfer to the trust was not fraudulent.[117] As currently amended, the statute provides that the settlor's creditors may satisfy claims from the trust assets to the extent of the settlor's beneficial interest therein, if at the time the trust was established or amended:

   a. the settlor was the sole beneficiary of the trust or retained the power to revoke or amend the trust; or

   b. the settlor was one of a class of beneficiaries and retained a right to receive a specific portion of the trust's income or principal.[118] Attorneys in Missouri and other states quietly took advantage of this provision.

2. However, at least one court has declared that the Missouri Statute did not change the existing rule that prohibited self-settled spendthrift trusts.[119]

3. On July 9, 2004, the Missouri legislature enacted a version of the Uniform Trust Code.[120] As part of this legislation, the spendthrift statute was clarified to state that with respect to an irrevocable trust with a spendthrift provision, the spendthrift provision will prevent a settlor's creditors from satisfying claims from the trust assets. Two exceptions, similar to the prior law, were provided:

   a. Spendthrift protection is not provided if the transfer of assets to the trust is fraudulent.

   b. Spendthrift protection is not provided if the settlor is the sole beneficiary of the income or principal of the trust or retained the power to amend the trust or if the settlor is one of a class of beneficiaries and retained a right to receive a specific portion of the income or principal of the trust.[121]

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[117] See Mo. Ann. Stat. § 456.080.3(1) (West 2000).

[118] See id. at § 456.080.3(2).

[119] See In re Enfield, 133 B.R. 515, 519 (Bankr. W.D. Mo. 1991).

[120] See Missouri House Bill 1511 (West 2004).

[121] See Mo. Ann. Stat. § 456.5-505.3.

4. Thus, under Missouri law, if there is more than one beneficiary of the trust, the settlor is a discretionary beneficiary of the income or principal, and the trust contains a spendthrift provision, spendthrift protection will be given to the settlor of a trust.

5. The Missouri law is less restrictive than the laws in other states with domestic asset protection trust legislation. For example, a Missouri trustee is not required for the trust.

6. Because the Missouri law differs significantly from the statutes in the other asset protection trust states, practitioners do not seem to focus on the Missouri asset protection trust as a possible alternative for their clients. However, Missouri practitioners report having positive experiences with the Missouri trust as an asset protection technique for clients.

B. Statutory Domestic Asset Protection Trusts.

In 1997, Alaska and Delaware enacted legislation to permit the settlors of a trust to remain a trust beneficiary, but still obtain spendthrift protection. Proponents of the Alaska and Delaware statutes assert that they offer the same opportunity to protect one's assets from creditors that is otherwise available only with offshore trusts created in certain debtor friendly jurisdictions. Determining the truth of this will take some time. In 1999, Nevada and Rhode Island enacted similar legislation. In 2003, Utah enacted legislation to permit the settler of a trust to obtain spendthrift protection as a beneficiary, but only with respect to personal property transferred to the trust. South Dakota enacted legislation to permit creditor protection for self-settled trusts in 2005 and Wyoming and Tennessee enacted legislation in 2007.[122] New Hampshire enacted legislation in 2008.[123] Hawaii enacted legislation in 2010.[124] Virginia enacted legislation in 2012.[125] Ohio enacted the Ohio Legacy Trust Act, which became effective March 27, 2013.[126] Mississippi enacted the Mississippi Qualified Disposition in Trust Act on April 23, 2014, which became effective July 1, 2014.[127] West Virginia passed legislation on March 10, 2016, which became effective on June 10, 2016.[128] Michigan

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[122] Wy. Stat. Ann. § 4-1-505 and §§ 4-10-510 to 4-10-523 and Tenn. Code § 35-15-504.

[123] N.H. Rev. Stat. § 547-3-K.

[124] Hawaii Rev. Stat. § 554G.

[125] Va. Code § 64.2-745.1.

[126] Ohio Rev. Code Ann. § 5816.01 et seq.

[127] Miss. Code § 91-9-701 et seq.

enacted legislation on December 5, 2016 that became effective on February 5, 2017.[129]

In almost every other state, settlors of trusts are denied spendthrift protection. This is derived from the English "Statute of Elizabeth," which is embodied in The Restatement (Second) of Trusts as follows:

"§ 156. Where the Settlor is a Beneficiary.

a. Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.

b. Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."[130]

1. This provision of the Restatement has been applied in many reported cases and appears to be the commonly-held view of estate planning professionals throughout the United States. The commonly-held view may not apply universally, and there may be a number of exceptions to the rule.[131] However, it is clear that most practitioners advise their clients that a self-settled trust cannot insulate assets from the claims of the settlor's creditors as long as the settlor retains any interest in the trust.

2. One practical effect of the foregoing rule is that the rights of creditors to reach a discretionary self-settled trust in which the settlor retains an interest causes any gift made by the settlor to the trust to be incomplete for federal gift tax purposes. In order for a transfer to be a completed gift under section 2511 of the Internal Revenue Code, the donor must have "so parted with dominion and control as to leave in him no power to change its disposition. . . ."[132] The Internal Revenue Service has ruled that "the transfer of property to an irrevocable inter vivos trust created in, and

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[128] West Va. Code § 44D-5-503a et. seq.

[129] 2016 Mich. A.L. § 330.

[130] Restatement (Second) of Trusts, § 156 (1959).

[131] See, e.g., Robert L. Manley, Estate Planning with Self Settled Spendthrift Trusts: Steering Clear of Debts and Taxes, SD36 A.L.I.-A.B.A. 91, 96 (1999).

[132] 26 C.F.R. § 25.2511-2(b).

administered under the laws of, a state in which the trust is deemed a discretionary trust" whose assets are subject to claims of the settlor's creditors, does not constitute a completed gift."[133] The Service went on to state:

> If and when the settlor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a state where the settlor's creditors cannot reach the trust assets, then the gift is complete for federal gift tax purposes under the rules set forth in regulation 25.2511-2.[134]

3. A further consequence of a creditor's ability to reach the settlor's interest in a self-settled trust is that the assets in the trust will continue to be part of the settlor's gross estate for federal estate tax purposes under one or both of Internal Revenue Code section 2036 and Internal Revenue Code section 2038.

C. Alaska Trusts. In apparent response to the high-profile discussion of offshore trusts in the asset protection arena (and probably because of the reticence of many American practitioners and their clients to the uncertainty of adopting the laws of an unfamiliar foreign country), Alaska's legislature enacted the "Alaska Trust Act" (the "Alaska Act") which became effective April 2, 1997. On July 10, 2003, new legislation became effective that considerably strengthens the Alaska Act, including increased creditor protection both for third-party beneficiaries and for asset-protection trusts.[135]

1. Rule Against Perpetuities. The Alaska Act effectively eliminates the rule against perpetuities.

2. Creditor Protection. The Alaska Act allows a person to set up a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. This Act permits trusts that go beyond the typical trust for heirs sheltering the trust corpus and income from creditors through spendthrift provisions allowing the trustee to retain trust income and corpus if any given beneficiary is attacked by creditors. The Alaska Act provides that, outside of some specific situations discussed below, the assets of a trust governed by the Act are not subject to the claims of the settlor's creditors unless the original transfer to the trust was intended to defraud the settlor's known creditors or renders the settlor insolvent.[136] Thus, a settlor can

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[133] Revenue Ruling 76-103, 1976-1 C.B. 293.

[134] Id.

[135] 2003 Alaska Laws Ch. 138 (H.B. 212)

[136] See Alaska Stat. § 34.40.110(b)(1) (West 2000).

transfer assets to an irrevocable Alaska Trust and be a beneficiary to whom the trustee can distribute trust property, and, if the trust is not obligated to distribute trust assets to the settlor, the assets will not be subject to creditors' claims.[137] This protection applies even if the settlor is the only person to whom the trustee may distribute trust assets and income. If there are beneficiaries in addition to the settlor, this protection from creditors' claims applies even if the settlor retains the right to veto distributions to other trust beneficiaries or the right to direct where trust property passes on his or her death.[138] Prior to the 2003 amendments to the Alaska Act, the assets of an irrevocable Alaska Trust could be attached at any time by a creditor whose claim existed at the time the trust was settled, even if the claim were not known to the settler at that time. The new amendments prohibit such a pre-existing creditor from attaching trust assets unless the creditor either (i) demonstrates that he or she asserted a specific claim against the settler before the assets were transferred to the trust, or (ii) files a court action against the settler within four years after the transfer of assets to the trust asserting an act or omission that occurred before the transfer.[139]

3. Limitations. There are limitations to the Alaska Act. A creditor under section 34.40.110 as amended by the Alaska Act is able to reach the trust assets to the extent necessary to pay the creditor's claim if:

   a. The creditor can prove the transfer was made with an intent to defraud that creditor under AS § 34.40.010. Prior to the 2003 amendments, this provision required, as in most other states, only a showing that the transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons;

   b. the settlor retains the power to revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust;

   c. the trust requires that all or part of the trust's income or principal, or both, must be distributed to the settlor; or

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[137] See id. at § 34.40.110(b)(3).

[138] See id. at § 34.40.110(b)(2).

[139] See id. at § 34.40.110(d).

d. at the time of transfer, the settlor is in default by thirty or more days of making a payment due under a child support judgment or order.[140]

4. Applicability of Alaska Act. To qualify a trust under the Alaska Act, some or all of the trust assets must be deposited in Alaska,[141] part or all of the trust administration must take place in Alaska,[142] and the settlor must use an Alaska resident or an Alaska-headquartered bank or trust company as trustee or co-trustee.[143] This trustee must have certain duties including selecting the trust tax return preparer and maintaining certain trust records.[144]

D. Delaware Trusts. Delaware, long known as a trust-friendly jurisdiction based on a variety of other tax and legal rules, quickly responded to the Alaska legislation. On July 9, 1997 Delaware Governor Carper signed into law the "Qualified Dispositions in Trust Act" (the "Delaware Act"). The Delaware Act provides creditor protection and estate planning opportunities similar to those in the Alaska statute described above.

1. Creditor Protection. As in the Alaska Act, the Delaware Act allows an individual to set up a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The Delaware Act defines the creation of a "qualified disposition" as the creation of an irrevocable trust with the appropriate trustee, which contains a spendthrift provision and which incorporates the laws of Delaware.[145] Outside of some specific situations discussed below, the assets in trust are not subject to the claims of the settlor's creditors in the courts of Delaware. Thus, as in Alaska, a settlor can transfer assets to an irrevocable Delaware Trust and be a beneficiary to whom the trustee can distribute trust property and, if the trust is not obligated to distribute certain trust assets to the settlor, the assets will not be subject to creditors' claims. This protection applies even if the settlor is the only person to whom the trustee may distribute trust assets and income. If there are beneficiaries in addition to the settlor, this protection from creditors' claims applies even if the settlor retains the

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[140] See id. at § 34.40.110(b).

[141] See id. at § 13.36.035(c)(1).

[142] See id. at § 13.36.035(c)(4).

[143] See id. at § 13.36.035(c)(2); § 13.36.390(1).

[144] See id. at § 13.36.035(c)(3).

[145] See Del. Code Ann. tit. 12, § 3570(6), (10) (West 2000), as amended by 2000 Del. Laws ch. 341, §3.

right to veto distributions to other trust beneficiaries or the right to direct where trust property passes on his or her death.[146] The Delaware Act differs from other self-settled spendthrift statutes in that it permits the settlor to retain the right to receive trust income.[147]

2. Limitations. There are limitations under the Delaware Act. Creditors under sections 3572, 3573 and 3574 are able to reach the trust assets to the extent necessary to pay the creditor's claims and related costs (including attorney's fees) if:

   a. the transfer was to defraud creditors;[148]

   b. the claim resulted from an agreement or a court order providing for alimony, child support or property division; or

   c. if the creditor suffers death, personal injury or property damage as a result of action by the settlor, directly or indirectly, before the date of the transfer for which the transferor is liable.[149]

3. Applicability of Delaware Act. Similarly to the Alaska requirements, to qualify a trust under the Delaware Act, the settlor must use a Delaware resident or a corporate trustee authorized by Delaware law to act as a trustee and whose activities are subject to supervision by the Bank Commissioner of Delaware, the Federal Deposit Insurance Corporation, the Comptroller of the Currency or the Office of Thrift Supervision. Furthermore, the trustee must "materially participate" in trust administration.[150]

4. Rule Against Perpetuities. Delaware had previously effectively eliminated the Rule Against Perpetuities except for real property interests.[151]

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[146] See 2000 Del. Laws ch. 341, §3 (to be codified at Del. Code Ann. tit. 12, § 3570(10)(b)).

[147] See id. (trust instrument is not deemed revocable on account of its inclusion of the settlor's "potential or actual receipt of income, including rights to such income retained in the trust instrument").

[148] The Delaware Act's statute of limitations in § 3572(b) is identical to the Alaska Act. See 2000 Del. Laws ch. 341, § 7 (to be codified at Del. Code Ann. tit. 12, § 3572(b)); Del. Code Ann. tit. 6, § 1309; see also §§ 1304 and 1305 of Title 6 for a definition of a transfer in fraud of creditors.

[149] See Del. Code Ann. tit. 12, §§ 3536(a), 3573, 3574(a).

[150] See id. at § 3570(9).

[151] See Del. Code Ann. tit. 25, §503(a).

Accordingly, the Delaware Act did not need such a provision as was contained in the Alaska Act.

5. Advantages of Delaware Act. One possible advantage of the Delaware Act is the provision that provides that the trustee of a Delaware asset protection trust automatically ceases to act if a non-Delaware court determines that a court has jurisdiction over either the trustee or the trust assets. Del. Code Ann. tit. 12, § 3572(g). This may permit a creator of a Delaware trust to have the trust assets automatically moved to an offshore trustee if a non-Delaware court asserted jurisdiction. Other possible advantages include (i) a specific provision to address Revenue Ruling 2004-64, 2004-27 I.R.B. 7, mandating that the settler of a Delaware trust may only retain the ability to be reimbursed for income taxes payable on income attributable to a Delaware trust on a discretionary basis, Del. Code Ann. Tit. 12, § 3570(10)(b)(9) and (ii) a provision that the surviving spouse of the settlor of a Delaware trust cannot elect against the settlor's will. Del. Code Ann. Tit 12, § 3573.

E. Nevada Trusts. On October 1, 1999, Nevada enacted the "Spendthrift Trust Act of Nevada" (the "Nevada Act"). The Nevada Act provides creditor protection and estate planning opportunities similar to those in the Alaska and Delaware statutes described above.

1. Creditor Protection. The Nevada Act, like the Alaska Act and the Delaware Act, enables a person to establish a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The Nevada Act provides that, except in certain circumstances, the assets of a trust governed by the statute are not subject to the claims of the settlor's creditors unless the original transfer to the trust was intended to defraud the settlor's creditors. Thus, as in Alaska and Delaware, a settlor can transfer assets to an irrevocable Nevada Trust and be a beneficiary to whom the trustee may distribute trust property, and, if the trust is not obligated to distribute trust assets to the settlor, the assets will not be subject to creditors' claims.[152] This protection applies even if the settlor is the only person to whom the trustee may distribute trust assets and income. If there are beneficiaries in addition to the settlor, this protection from creditors' claims applies even if the settlor retains the right to veto distributions to other trust beneficiaries or the right to direct where trust property passes on his or her death.[153]

2. Limitations. There are limitations to the Nevada Act. A creditor is able to reach the trust assets to the extent necessary to pay the creditor's claim if:

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[152] See Nev. Rev. Stat. § 166.040.1(b) (West 2000).

[153] See id. at § 166.040.2(a).

a. the transfer was intended to hinder, delay, or defraud known creditors;[154]

b. the trust is revocable; or

c. the trust requires that any part of the trust's income or principal must be distributed to the settlor.[155]

3. Applicability of Nevada Act. Similarly to the Alaska and Delaware requirements, to qualify a trust under the Nevada Act, all or part of the trust property must be located and administered in Nevada and the settlor must use as trustee or co-trustee a Nevada resident or a bank or trust company that maintains an office in Nevada for the transaction of business.[156] This trustee must have certain powers including preparing income tax returns for the trust and maintaining trust records.[157]

F. Rhode Island Trusts. In 1999, Rhode Island enacted the "Qualified Dispositions in Trust Act" (the "Rhode Island Act"), which provides creditor protection and estate planning opportunities almost identical to those in the Delaware Act described above.

1. Creditor Protection. As in the Delaware Act, the Rhode Island Act allows an individual to set up a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The Rhode Island Act defines a "qualified disposition" as the creation of an irrevocable trust with the appropriate trustee, which contains a spendthrift provision and which incorporates the laws of Rhode Island.[158] Except for some specific situations discussed below, the assets in trust are not subject to the claims of the settlor's creditors in the courts of Rhode Island. Thus, as in Delaware, a settlor can transfer assets to an irrevocable Rhode Island Trust and be a beneficiary to whom the trustee can distribute trust property and,

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[154] See id. at § 166.170, statute of limitations for actions against transfers in fraud of creditors: "A person may not bring an action with respect to a transfer of property to a spendthrift trust: (1) If he is a creditor when the transfer is made, unless the action is commenced within: (a) Two years after the transfer is made; or (b) Six months after he discovers or reasonably should have discovered the transfer, whichever is later. (2) If he becomes a creditor after the transfer is made, unless the action is commenced within two years after the transfer is made."

[155] See id. at § 166.040.1(b).

[156] See id. at § 166.015.

[157] See id. at § 166.015.1(d).

[158] See R.I. Gen. Laws §§ 18-9.2-2(6), (9) (West 2000).

if the trust is not obligated to distribute trust assets to the settlor, the assets will not be subject to creditors' claims. This protection applies even if the settlor is the only person to whom the trustee may distribute trust assets and income. If there are beneficiaries in addition to the settlor, this protection from creditors' claims applies even if the settlor retains the right to veto distributions to other trust beneficiaries or the right to direct where trust property passes on his or her death.[159] Unlike the Delaware Act, the Rhode Island Act does not permit the settlor to retain the right to receive trust income.

2. Limitations. There are limitations under the Rhode Island Act. Creditors are able to reach the trust assets to the extent necessary to pay the creditor's claims and related costs (including attorney's fees) if:

   (1) the transfer was to defraud creditors;[160]

   (2) the claim resulted from an agreement or a court order providing for alimony, child support or property division; or

   (3) if the creditor suffers death, personal injury or property damage as a result of action by the settlor, directly or indirectly, before the date of the transfer for which the transferor is liable.[161]

3. Applicability of Rhode Island Act. As under the Delaware Act, to qualify a trust under the Rhode Island Act, the settlor must use a Rhode Island resident or a corporate trustee authorized under Rhode Island law to act as a trustee and whose activities are subject to supervision by the Department of Business Regulation of Rhode Island, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, or the Office of Thrift Supervision. Furthermore, the trustee must "materially participate" in trust administration.[162]

4. Rule Against Perpetuities. Rhode Island had previously abolished the Rule Against Perpetuities in 1983.[163]

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159 See id. at § 18-9.2-2(9)(b).

160 The Rhode Island Act's statute of limitations in § 18-9.2-4 are identical to that of the Alaska Act. See id. at 18-9.2-4(b).

161 See id. at §§ 18-9.2-6(a), 18-9.2.4(a), 18-9.2-5.

162 See id. at § 18-9.2-2(8).

163 See id. at § 34-11-38.

G. Utah Trusts. On March 22, 2003, Utah amended Section 25-6-14 of its Uniform Fraudulent Transfer Act to permit a settler to transfer personal property to a trust created on or after May 5, 2003 and obtain spendthrift protection. The amendment became effective on December 31, 2003.

1. Creditor Protection. For irrevocable trusts created on or after May 5, 2003, a settlor may provide that the income or principal interest of the settlor as beneficiary of the trust will be protected from creditors. This protection applies only to personal property and not to real estate put into trust. The trustee must have discretion to pay out income and principal to the settlor and other beneficiaries. The settlor may retain a power to veto a distribution from the trust, may have a testamentary power of appointment over the trust and may have the power to appoint non-subordinate advisors to trust protectors who can remove and appoint trustees, who can direct, consent to or disapprove distributions or can serve as an investment director or appoint an investment director.

2. Limitations. There are limitations under the Utah Act. Creditors are able to reach the trust assets to the estate necessary to pay creditor's claims under the following conditions:

   a. The transfer was to defraud creditors;

   b. The trust is revocable without the consent of a person with a substantial adverse interest in the trust;

   c. At the time of the transfer, the settlor or beneficiaries in default by 30 or more days in making a payment due under child support judgment or order;

   d. The transfer renders the settlor or beneficiary insolvent under the transfer.

   e. At the time of the transfer, or any time thereafter, the person receives public assistance and recovery is allowed the medical benefits recovery act, or

   f. The settlor is or becomes subject to a state claim or tax.

3. Applicability of the Utah Act. To qualify a trust under the Utah Act, the settler must use as trustee (i) a Utah depository institution or its wholly owned subsidiary, or an out-of-state depository institution authorized to engage in business as a depository institution in Utah, (ii) a corporation, including a credit union service organization, owned entirely by one or more federally insured depository institutions, (iii) a direct or indirect subsidiary of a depository institution holding company that also has a direct or indirect subsidiary authorized to engage in business as a depository institution in Utah, or (iv) any other corporation continuously

engaged in the trust business in Utah since before July 1, 1981. The Utah Act becomes effective on December 31, 2003.

4. Rule Against Perpetuities. Utah has established a 1,000 year rule against perpetuities.[164]

H. South Dakota Trusts. On March 2, 2005, South Dakota enacted Senate Bill No. 93 to permit a settlor to transfer property to a trust created on or after July 1, 2005 and obtained spendthrift protection.[165] This statute was modeled closely on the Delaware statute.

1. Creditor Protection. As in the Delaware statute, the South Dakota Act allows an individual to set up a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The trust must be an irrevocable trust with the appropriate trustee which contains a spendthrift provision and which incorporates the laws of South Dakota. Except for some specific situations discussed below, the assets in the trust are not subject to the claims of the settlor's creditors in the courts of South Dakota. Thus, as in Delaware, the settlor can transfer assets to an irrevocable South Dakota trust and be a beneficiary to whom the trustee can distribute trust property and, if the trust is not obligated to distribute trust assets to settlor, the assets will not be subject to creditors' claims. This protection applies even if settlor is the only person to whom the trustee may distribute trust assets and income. If there are beneficiaries in addition to the settlor, the protection from creditors' claims applies even if the settlor retains the right to veto a distribution from the trust. Like Delaware, the settlor can retain the right to receive the income from the trust or a unitrust amount.

2. Limitations. There are limitations under the South Dakota Act. Creditors are able to reach the trust assets to the extent necessary if (i) the transfer was to defraud creditors; (ii) the claim resulted from an agreement or court order providing for alimony, child support, or property division; or (iii) if the creditor suffers death, personal injury or property damage as a result of an action by the settlor, before the date of the transfer for which the transfer is viable.

3. Applicability of South Dakota Act. As under the Delaware Act, to qualify a trust under the South Dakota Act, settlor must use a South Dakota resident or corporate trustee authorized under South Dakota law to act as a trustee whose activities are subject to supervision by the South Dakota Division of Banking, the Federal Deposit Insurance Corporation, the

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164 Utah Code Annotated, § 75-2-1203.

165 South Dakota Codified Laws, §§ 55-16-1, et seq.

Comptroller of the Currency or the Office of Thrift Supervision. The trustee must maintain or arrange for custody in South Dakota of some or all of the property, must maintain records for the trust on an exclusive or nonexclusive basis, must prepare or arrange for the preparation of fiduciary income tax returns, and must otherwise materially participate in the administration of the trust.

4. Rule Against Perpetuities. South Dakota had previously abolished the rule against perpetuities.

I. Wyoming Trusts. On February 28, 2007, Wyoming amended its law to permit settlors to establish asset protection trusts in Wyoming, which are designated "Qualified Spendthrift Trusts" and receive protection from creditors when certain conditions are met.[166] The Wyoming Act is based on the Delaware Act.

1. Creditor Protection. For irrevocable trusts created on or after July 1, 2007, the settlor may provide that the income or principal interest of the settlor as a beneficiary of the trust will be protected from creditors. This protection applies to both personal property and real estate. The trustee must have the discretion to pay out income and principal to the settlor and other beneficiaries. The settlor may maintain certain rights, including the power to veto a distribution from the trust, the ability to have an inter vivos or testamentary general or limited power of appointment, and the right to act as an investment advisor to the trust. The ability to have an inter vivos or testamentary general power of appointment differs from the other asset protection trust states that will permit the settlor to have a limited power but not a general power.

2. Limitations. Creditors are able to reach the trust assets to the extent necessary if (i) the transfer was a transfer to defraud creditors or (ii) a claim resulted from a child support order.

3. Applicability. A Wyoming trust must be an irrevocable trust that specifically states that it is a qualified spendthrift trust and is to be governed by Wyoming law. At least one of the trustees must be an individual who is a resident of Wyoming or a Wyoming corporate fiduciary. The Wyoming trustee must "materially participate" in the administration of the Wyoming trust. Material participation includes holding some of the trust property in Wyoming, maintaining records for the trust on an exclusive or non-exclusive basis, and preparing or arranging for the preparation of fiduciary income tax returns for the qualified spendthrift trust.

[166] Wy. Stat. §§ 4-1-505 and 4-10-510 through 4-10-523.

At the time of creation, the settlor must furnish a solvency affidavit and affirm that the settlor is not in default of any child support obligation and does not contemplate filing for bankruptcy. Wyoming, unlike other domestic asset protection trust states, appears to require the settlor to maintain personal liability insurance of the lesser of $1,000,000 or the total value of the property transferred by the settlor to all Wyoming qualified spendthrift trusts for his or her benefit.

4. Rule Against Perpetuities. Wyoming had previously established a 1,000 year rule against perpetuities for personal property if a specific decision is made to opt out of the rule against perpetuities.[167]

J. Tennessee Trusts. On May 1, 2007, Tennessee enacted the "Tennessee Investment Services Act of 2007" which permits the creation of domestic asset protection trusts in Tennessee which are called "Investment Services Trusts."[168] This legislation is effective July 1, 2007. The asset protection trust provisions for the Tennessee Act are similar to the Wyoming legislation and follow, in many ways, the Delaware legislation.

1. Creditor Protection. The Tennessee Act allows an individual to set up a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The trust must be an irrevocable trust. The assets in the trust are not subject to the claims of the settlor's creditors in the courts of Tennessee. The settlor is permitted to retain certain rights without jeopardizing the spendthrift protection. These include the power to veto a distribution from the trust, the ability to have a testamentary limited power of appointment, and the right to act as investment adviser.

2. Limitations. Similarly to all the domestic asset protection trust statutes, creditors can reach the qualified trust property if the transfer of property was a fraudulent transfer under the Tennessee Fraudulent Transfer Act. However, Tennessee does not, like other asset protection trust states, carve out an exception to spendthrift protection for child support obligations.

3. Applicability of the Tennessee Act. As under the Tennessee Act, the settlor must use a Tennessee resident or corporate trustee. The trust must contain a spendthrift provision and incorporate the laws of Tennessee. The trustee must maintain or arrange for custody in Tennessee if some or all of the property, must retain records for the trust, must prepare or arrange for preparation of fiduciary income tax returns, and must otherwise materially participate in the administration of the trust. The settlor must provide a solvency affidavit.

[167] Wy. Stat. § 34-1-139 (b).

[168] Tenn. Code §§ 35-15-505 and 61-1-202.

4. Rule Against Perpetuities. Tennessee, as part of the legislation, amended its rule against perpetuities to extend the period to 360 years if a testamentary power of appointment is granted to at least one member of each generation of beneficiaries who are beneficiaries of the trust more than ninety years after the creation of the trust.[169]

K. New Hampshire Trusts. The New Hampshire legislature on July 8, 2008 adopted the "Qualified Dispositions in Trust Act" to, among other things, permit domestic asset protection trusts to be created in New Hampshire on and after January 1, 2009. [170] The asset protection trust provisions of the New Hampshire legislation are similar to the Delaware legislation. Interestingly, the New Hampshire legislature also adopted trust protector and decanting legislation at the same time. Reasons give for enacting the legislation included: (i) the rapidly growing national market for trusts and fiduciary services; (ii) New Hampshire's unique position to provide the most attractive legal and financial environment for trusts and investment assets; and (iii) attracting good paying jobs to New Hampshire.

1. Creditor Protection. The New Hampshire Act allows an individual to set up a self settled spendthrift trust that is immunized from most claims of the settlor's creditors. The trust must be an irrevocable trust. The assets in the trust are not subject to the claims of the settlor's creditors in New Hampshire courts. The settlor is permitted to retain certain rights without jeopardizing the spendthrift protection. These include the power to veto distributions from the trust and the ability to have a testamentary special power of appointment over the trust assets.

2. Limitations. Similarly to all the Domestic Asset Protection Trust statutes, creditors can reach the qualified trust property if the transfer of property to the New Hampshire trust was a fraudulent transfer under the New Hampshire Uniform Fraudulent Transfer Act. Two classes of creditors are exempt from the provisions protecting trust assets. These are child support obligations and those stemming from alimony or spousal support.

3. Applicability of the New Hampshire Act. As under the Delaware Act, the settlor must use a New Hampshire individual or corporate trustee. The trust must contain a spendthrift provision and incorporate the laws of New Hampshire. The trustee must maintain or arrange for custody in New Hampshire of some or all of the trust property, must retain records for the trust, must prepare or arrange for preparation of fiduciary income tax returns, and must otherwise materially participate in the administration of the trust.

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[169] Tenn. Code § 66-1-202(f).

[170] N.H. Rev. Stat. § 564-D.

4. Rule Against Perpetuities. New Hampshire preserves the rule against perpetuities but provides an exception for trusts created after December 31, 2003 if the instrument expressly exempts the trust from the rule against perpetuities and the trustee has the power to sell mortgaged or leased property for a period beyond the Rule.

L. Hawaiian Trusts. The Hawaii legislature on April 27, 2010, adopted the "Permitted Transfers in Trust Act," to permit domestic asset protection trusts to be created in Hawaii on and after July 1, 2010.171 Governor Lingle signed the bill into law on June 28, 2010. The Hawaiian asset protection trust provisions, while similar to those in many of the other asset protection states, have some unique provisions. The purpose of the Hawaiian act was to "build on proven domestic and international estate and financial planning methodologies for the purpose of attracting foreign source capital." The act was designed to encourage high net worth individuals to transfer a portion of their liquid net worth into Hawaii for asset and trust management, thereby increasing tax revenues and positioning Hawaii as a world-class financial management jurisdiction.

1. Creditor Protection. The Hawaii Act allows an individual to set up a self-settled spendthrift trust that is protected from most claims of the settlor's creditors. The trust must be an irrevocable trust. The assets in the trust are not subject to the claims of the settlor's creditors in Hawaiian courts. The settlor is permitted to retain certain rights without jeopardizing the spendthrift protection. These include:

- The power to veto a distribution from the trust;
- A limited testamentary power of appointment;
- Mandatory right to income;
- Receipt of a fixed annuity or unitrust amount not exceeding five percent;
- The right to or receipt of discretionary distributions of principal;
- The right to remove a trustee or advisor and appoint a new trustee or advisor;
- The ability to act as investment advisor to the trust;
- The right to or actual receipt of distributions to pay income tax due on income of the trust; and
- Trustee's authority to pay all or part of the settlor's debts at the time of settlor's death.

[171] Hawaii Rev. Stat. 554G.

2. Limitations. As under most domestic asset protection trust statutes, creditors can reach the property if the transfer was a fraudulent transfer. Several classes of creditors are exempt from the provisions protecting the trust assets. These include child support; obligations stemming from alimony or spousal support; personal injury claims arising on or before the date of the transfer; a lender who extends a secured or collateralized loan based on the express or implied representation that the assets of the trust would be available as security; and the State of Hawaii when a settlor is unable to meet his or her tax liabilities.

3. Applicability of the Hawaii Act. The settlor must use a Hawaii individual or corporate trustee. The trust must contain a spendthrift provision and incorporate the laws of Hawaii. A Hawaiian corporate trustee must have its principal place of business in Hawaii.

4. Unique Provisions. The act specifically permits the appointment of trust protectors (also referred to as advisors). The trust protector may have the power (i) to remove and appoint permitted trustees, advisors or protectors, (ii) to direct, approve, or disapprove distributions from the trust, and (iii) to act as investment advisor to the trust. The transferor must provide an affidavit stipulating to this requirement as well as stipulating that the transfer is not one in fraud of creditors. Hawaii levies a one time, 1% excise tax on the fair market value of all property transferred into the trust.

5. Rule against Perpetuities. Hawaii specifically excludes domestic asset protection trusts from the Hawaii rule against perpetuities.

M. Virginia Trusts. Virginia enacted domestic asset protection trust legislation in 2012 that became effective July 1, 2012. The Virginia legislation is similar to the domestic asset protection trust legislation in other states by permitting the creation of a "qualified self-settled spendthrift trust." [172]

1. Creditor Protection. The Virginia legislation allows an individual to set up a self-settled spendthrift trust that is protected from most claims of the settlor's creditors. The trust must be an irrevocable trust. The assets in the trust are not subject to the claims of the settlor's creditors in Virginia courts. The settlor is permitted to retain certain rights without jeopardizing the spendthrift protection.

2. Limitations. The trust must be irrevocable. The settlor must be entitled only to discretionary distributions of income and principal. The transfer to the trust may not be a fraudulent transfer. Several features of the Virginia legislation may make it less attractive than the legislation in other

[172] Va. Code § 55.545-03:2 (repealed as of October 1, 2012) and replaced by Va. Code § 64.2-745.1 (effective October 1, 2012).

domestic asset protection trust states. First, there is a five-year period in which creditors at the time of the creation of the trust may bring a claim. This is longer than the period in other domestic asset protection trust states. Second, the settlor may not retain a power to disapprove distributions while such a veto power is common in other domestic asset protection trust states. Third, the person or entity who approves distributions must meet the requirements for a qualified trustee, which under the Virginia law means an independent trustee. Spouses, descendants, siblings, parents, employees, and entities in which the settlor controls thirty percent of the vote are specifically excluded. Other domestic asset protection trust states are less restrictive as to who can act as a co-trustee or distribution director to make distribution decisions. Fourth, only the right of the settlor to receive distributions of income and principal from the trust is protected from the claims of creditors. This may not protect all the assets in a Virginia self-settled spendthrift trust from the claims of creditors.

3. Applicability. There must be a Virginia trustee who maintains custody within Virginia of some or all of the trust property, maintains records within Virginia, prepares within Virginia fiduciary income tax returns for the trust, or otherwise materially participates within Virginia in the administration of the trust.

4. Rule Against Perpetuities. Virginia allows a trust to opt out of the Rule Against Perpetuities.

N. Ohio Legacy Trust Act.

1. Ohio became the fourteenth state to permit Domestic Asset Protection Trusts when the Ohio Legacy Trust Act was signed by the governor on December 20, 2012. [173] The Ohio Act became effective on March 27, 2013.

2. Creditor Protection. The Ohio legislation allows an individual to establish a self-settled spendthrift trust that is protected from most claims of the settlor's creditors. The trust must be an irrevocable trust. There must be an Ohio trustee. The trust must incorporate Ohio law and must specifically be a spendthrift trust. The creator of the trust, in addition to having the right to discretionary distributions of income and principal, can have the following rights:

    a. To veto distributions from the trust;

    b. To withdraw up to five percent of the value of the trust assets each year;

[173] Ohio Rev. Code Ann. §5816.01 et seq.

c. To provide directions concerning the investments of the trust;

d. To remove and replace the trustee;

e. To continue to live in a residence held in the trust; and

f. To possess a limited power of appointment.

3. Limitations. The trust must be irrevocable. The trust does not offer protection against claims for child support, spousal support, or alimony.

4. Unique Provisions. The creator of an Ohio Legacy Trust is required to provide a "qualified affidavit" stating that the property being transferred to the trust was not derived from unlawful activities; the transferor has full right, title, and authority to transfer the property; the transfer will not render the transferor insolvent immediately after the transfer of property; the transferor does not intend to defraud any creditor by transferring the property to the Legacy Trust; there are no court actions against the transferor except for actions identified in the affidavit; the transferor is not involved in any administrative proceeding except for those that are identified; and the transferor does not contemplate filing for bankruptcy.

5. Applicability. There must be an Ohio individual or corporate trustee who maintains custody within Ohio of some or all of the trust property.

6. Rule Against Perpetuities. Ohio allows a trust to opt-out of the Rule Against Perpetuities.

O. Mississippi Qualified Disposition in Trust Act.

1. Mississippi became the fifteenth state to enact domestic asset protection trust legislation when the Mississippi Qualified Disposition in Trust Act became effective on July 1, 2014. The Mississippi Act appears to follow the Tennessee Investment Services Trust Act, which was enacted in 2007.

2. Creditor Protection. The Mississippi Act allows an individual to set up a self-settled spendthrift trust that is protected from some claims of a settlor's creditors. Under the Mississippi Act, a settlor who desires protection against creditors can transfer assets to an irrevocable trust that has an independent Mississippi trustee and is governed by Mississippi law with respect to its validity, construction, and administration, and the settlor may be a discretionary beneficiary of the income and principal of the trust. The Mississippi Act specifically provides for the appointment of advisers to make investment decisions. The Mississippi trustee must materially participate in the administration of the trust through such activities as (i) maintaining custody of some of the property in Mississippi, (ii) maintaining records of the trust on an exclusive or non-exclusive basis, and (iii) preparing or arranging for the preparation of income tax returns.

3. Retention of Powers by Settlor. The settlor of a Mississippi Qualified Trust can retain the following powers or rights (among others) without losing spendthrift protection:

   a. The power to veto a distribution from the trust.

   b. A limited testamentary power of appointment.

   c. The right to receive a payment from a charitable remainder annuity trust or charitable remainder unitrust.

   d. The right to receive an annual unitrust payment from a private unitrust that is not in excess of five percent.

4. Requirement of Qualified Affidavit. For a transfer to a Mississippi Qualified Trust to be effective, the settlor, before making the transfer to the trust, must sign a "Qualified Affidavit" which states:

   a. The transferor has full right, title, and authority to transfer the assets.

   b. The transfer will not render the transferor insolvent.

   c. The transferor does not intend to defraud a creditor by transferring assets to the trust.

   d. There are no unidentified pending or threatened court actions against the transferor.

   e. There are no unidentified pending or threatened administrative proceedings against the transferor.

   f. The transferor does not intend to file for bankruptcy.

   g. The assets being transferred were not derived from unlawful activities.

5. Requirement for General Liability Insurance Policy. One unique feature of the Mississippi Act is that the settlor must secure and have in place before the transfer a general liability insurance policy and, if applicable, a professional liability policy, with policy limits of at least $1 million for each such policy.

6. Limitations. The Mississippi Act provides a two-year statute of limitations period during which a creditor can bring an action against the

trust. In addition, the Mississippi Act permits the following types of claims against a Mississippi Qualified Trust at any time:

a. Claims for spousal support and alimony and for child support.

b. Tort claims for death, personal injury, or property damage that occurs at any time and is caused by the settlor or for which the settlor is vicariously liable. This provision makes the spendthrift protection offered by the Mississippi Trust to settlors less effective than the protection provided by the domestic asset protection trust laws of other states. This provision may owe its inclusion in part to the aftermath of the decision of the Mississippi Supreme Court in *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (1997), in which it undermined the protection conferred by a spendthrift trust by ruling that the assets of a spendthrift trust for a third party beneficiary may be reached by a beneficiary's tort creditors. This decision was overturned by the Mississippi legislature in 1998. The inclusion of this provision may also reflect the strength of the plaintiffs' bar in Mississippi.

c. Claims of the State of Mississippi or any political subdivision, including court restitution in a criminal matter.

d. Claims of a creditor up to $1.5 million if the transferor fails to maintain the required $1 million general liability or professional liability policies.

7. Protection to Trustee and Advisers. The Mississippi Act specifically provides liability protection to the trustee, advisers to the trust, and any person involved in the counseling, drafting, preparation, execution, or funding of a Mississippi Trust. This protection extends to the creation and funding of limited partnerships and limited liability companies, the units in which are subsequently transferred to the Mississippi Trust.

8. Less Attractive Features of Mississippi Act. Several provisions of the Mississippi Act or other Mississippi law make the Mississippi Qualified Trust less attractive than the domestic asset protection trusts in other jurisdictions. For one, Mississippi has the common law Rule Against Perpetuities, while other domestic asset protection states have either extended or eliminated the Rule Against Perpetuities. Mississippi has a state income tax, unlike many of the other domestic asset protection states. Finally, some commentators have noted that the possible loss of protection against creditors if the settlor fails to maintain the required liability insurance may prevent a transfer to the Mississippi Qualified Trust from being a completed gift.

9. Rule Against Perpetuities. Mississippi has the common law rule against perpetuities.

P. West Virginia Domestic Asset Protection Trust Legislation.

1. On March 10, 2016, the West Virginia Legislature passed Domestic Asset Protection Trust legislation. The governor approved the legislation on March 23, 2016 and the legislation became effective on June 10, 2016.

2. Creditor Protection. For any irrevocable trust created on or after June 10, 2016, a grantor may provide that the income or principal interest of a settlor as a beneficiary of the trust will be protected from creditors. The trust must be irrevocable and created during the grantor's lifetime. There must be a West Virginia trustee. Some of the assets of the trust must be maintained in West Virginia, records for the trust must be maintained within West Virginia on an exclusive or non-exclusive basis, and the preparation of income tax returns must be arranged for or occur in West Virginia. One of the West Virginia trustees must materially participate in some other way in the administration of the trust. The grantor may only be entitled to discretionary distributions of income and principal. There must be at least one beneficiary other than the grantor. No creditor or other person can bring a claim against a trustee, trust advisor, trust director or any other person involved in counseling, drafting, preparing or executing the Trust.

3. Limitations. The grantor cannot retain the right to disapprove distribution from the trust, but can retain a limited testamentary power of appointment. Creditors have a four-year period after a transfer to the trust to bring an action to challenge the transfer.

4. Applicability. The trust must provide that West Virginia law applies to validity, construction, and administration of the Trust. The trust must have a spendthrift provision.

5. Solvency Affidavit. At the creation, the grantor must provide a solvency affidavit (called a "Qualified Affidavit") and indicate that the property transferred to the trust was not derived from unlawful activities, the grantor has full power to transfer the property to the trust, the grantor will not be rendered insolvent by the transfer of the property, there is no intention to defraud any creditor, there are no pending court actions against the grantor except those specifically identified in an attachment, the grantor is not engaged in any administrative proceedings except those specifically identified, and the grantor does not owe alimony or child support.

6. Rule Against Perpetuities. West Virginia has the common law against perpetuities.

Q. Michigan Qualified Dispositions in Trust Act.

1. On December 5, 2016, Michigan's governor signed the Qualified Dispositions in Trust Act. This legislation will become effective on February 5, 2017.

2. Creditor Protection. For any irrevocable trust created on or after February 5, 2017, a grantor may provide that the income or principal interest of the grantor as beneficiary of the trust will be protected from creditors. The trust must be irrevocable and there must be a Michigan trustee. The Michigan trustee must arrange for custody in Michigan of some or all of the trust property and some of the records pertaining to the trust must be kept in Michigan. No creditor or other person can bring a claim against a trustee, a trust advisor, a trust director, or any other person involved in counseling on, drafting, preparing, or executing the trust.

3. Limitations. The grantor can retain the following rights:

   a. Direct trust and investment decisions;

   b. Remove and replace trustees;

   c. Veto distributions from the trust;

   d. Receive discretionary distributions of income and/or principal;

   e. Receive the income from the trust;

   f. Retain a special testamentary power of appointment;

   g. Receive an annuity or unitrust payment from a charitable remainder trust;

   h. Receive the annuity payments from a grantor retained annuity trust; and

   i. Receive an annuity from the trust of not more than 5 percent of the trust initial value.

   Creditors have a two year period after a transfer to the trust to bring an action to challenge the transfer.

4. Applicability. The trust must provide that Michigan law applies to validity, construction, and administration of the trust. The trust must have a spendthrift provision.

5. Solvency Affidavit. At the creation of the qualified trust, the grantor must provide a solvency affidavit (called a "Qualified Affidavit") and indicate the following:

   a. The grantor has the full right, title, and authority to transfer the property to the trust;

   b. The transfer of the property to the trust will not render the grantor insolvent;

   c. The grantor does not intend to defraud a creditor by transferring the property to the trust;

   d. The grantor does not know of or have reason to know of any pending or threatened court actions against the grantor except to the extent identified in an attachment to the affidavit;

   e. The grantor is not involved in any administrative proceedings except for administrative proceedings identified on an attachment to the affidavit;

   f. The grantor is not currently in arrears on a child support obligation by more than 30 days;

   g. The grantor does not contemplate filing for relief under the bankruptcy code; and

   h. The property being transferred to the trust was not derived from unlawful activities.

6. Rule against Perpetuities. Michigan has repealed the rule against perpetuities with respect to personal property, effective May 28, 2008.

R. Oklahoma Family Wealth Preservation Trust Act.

1. The Oklahoma Legislature passed the "Family Wealth Preservation Trust Act" in 2004. Under this Act, it is possible for a revocable trust to receive creditor protection. To achieve creditor protection, the trust must be established under Oklahoma law. It must have an Oklahoma bank as trustee. The only permissible beneficiaries of the trust are:

   a. The spouse of the grantor;

   b. Children;

   c. Grandchildren;

   d. Issue of deceased natural children or grandchildren; and

e. A tax-exempt charity.

2. The trust may only be funded with Oklahoma assets, which include stocks, bonds or debentures issued by an Oklahoma based company, a bond or other obligation issued by the State of Oklahoma, an account in an Oklahoma based bank, and real property located in the state of Oklahoma. An Oklahoma based company would include corporations, limited liability companies, limited partnerships, or limited liability partnerships.

3. If all the requirements are met, the principal and income of a preservation trust is exempt from creditors of the grantor up to $1 million in value. In addition, any incremental growth derived from the income retained by the trustee of a preservation trust over the $1 million limitation will also be protected.[174]

S. Colorado Asset Protection Trusts. Some commentators believe that Colorado law offers a certain degree of asset protection to settlors of trusts.[175] They point to Colo. Rev. Statutes. § 38-10-111, which reads as follows:

> Trusts for use of grantor void against creditors. All deeds of gift, all conveyances, and all transfers or assignments, verbal or written, of goods, chattels, or things in action, or real property, made in trust for the use of the person making the same shall be void as against the creditors existing of such person.

1. This statute is read as denying spendthrift protection with respect to creditors of trusts at the time the trust was created and if the transfer was made fraudulently. Fulton Investment Co. v. Smith, 27 Col. App. 279, 149 P. 444 (1915) aff'd. 64 Col. 33, 170 P. 1183 (1918). In Campbell v. Colorado C&I Co., 9 Col. 60, 10 P. 248 (1885), the Colorado Supreme Court held that this statute does not apply unless the principal purpose of the trust is for the use of the grantor. Thus, if the trust is not for the principal use of the grantor, spendthrift protection may be available for the grantor as well as the other beneficiaries of the trust.

2. In addition, in the case of In Re Baum, 22 F.3d 1014 (10th Cir. 1994), an individual experiencing marital difficulties put assets, including his residence, into trusts to preserve the separate property for his children from prior marriages, but reserved the right to live in the residence. Later the settlor filed for bankruptcy and the bankruptcy trustee attempted to set aside the trust. The appellate court, when the bankruptcy trustee

[174] See Oklahoma House Bill 2135.

[175] See Engel, Barry S., Lockwood, David L., and Merric, Mark, Asset Protection Planning Guide, ¶ 1125.05 (CCH 2000).

attempted to treat the trust as void under Colorado law, found that since the creditors did not exist at the time the trusts were created, the trusts were valid. The Court allowed the bankruptcy trustee to reach the value of the right of the settlor to live in the house during his lifetime, subject to the Colorado homestead exemption.

3. Because of the uncertain nature of the protection offered by the Colorado law, one could probably get more favorable results by looking to states which have specific asset protection trust statutes.

T. State Income Tax Considerations. As with perpetuities trusts, the selection of a state in which to establish an asset protection trust may depend, in part, on how that state taxes trust income. The income tax provisions for the domestic asset protection states are summarized below. Please note that while the settlor is alive, the trusts are usually treated as grantor trusts for income tax purposes.

1. Alaska. Alaska does not tax income.

2. Delaware. No tax on income allocable to nonresident beneficiaries. Delaware will tax income where the trust is created by a resident, the sole trustee is a resident or has an office in Delaware, corporate trustee has office in Delaware, or all trustees are individuals and at least half are residents.[176]

3. Hawaii. Hawaii taxes the income of a non-grantor trust. However, in SB 2842, the Hawaii legislature specifically provided that income or capital gains accumulated for the benefit of non-resident beneficiaries shall be excluded from Hawaii income tax. It also states that where the percentage interests of the beneficiaries are indeterminable, the trustee shall allocate accumulated income and gains equally among all beneficiaries entitled to distributions of income to determine the proportion of the trust income subject to tax in Hawaii.

4. Michigan. Michigan taxes the income of testamentary trusts created by Michigan residents. It also taxes the income of inter vivos trusts created by Michigan residents unless the trustees and beneficiaries are outside Michigan and the administration takes place outside Michigan.[177]

5. Mississippi. Mississippi taxes the income of a non-grantor trust that is administered in Mississippi.[178]

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[176] Del Code Ann. Tit. 30, § 1631.

[177] Mich. Comp. Laws § 8.206.16, 206.15 (1)(c), and 206.51 (1)(h)

[178] Miss. Code An. § 27-7-5(i)

6. Missouri. Missouri taxes the income of a trust that was created by, or consists of property contributed by, a person domiciled in Missouri on the date the trust becomes irrevocable if, on the last day of the taxable year, at least one income beneficiary of the trust is a resident of Missouri.[179]

7. Nevada. Nevada does not tax income.

8. New Hampshire. New Hampshire does not tax income. There is an intangibles tax on New Hampshire beneficiaries of New Hampshire trusts.[180]

9. Ohio. Ohio taxes the income of an intervivos trust created by an Ohio resident if there is a resident beneficiary in Ohio.[181]

10. Rhode Island. Rhode Island does not tax income allocated to non-resident beneficiaries. It will tax income allocated to resident beneficiaries for a trust created by a resident but only while the creator continues as a resident or after death if the creator is then a resident.[182]

11. South Dakota. South Dakota does not tax income.

12. Tennessee. Tennessee taxes the divided and interest income of a trust received by trustees "for the benefit" of resident beneficiaries.[183]

13. Utah. Utah taxes the income of (i) a trust, or portion of a trust, consisting of property transferred by will of a decedent who was domiciled in Utah at death, and (ii) a trust that is administered in Utah. A trust is administered in Utah if (i) the place where the fiduciary transacts a major portion of its administration of the trust is in Utah, or (ii) the usual place of business of the fiduciary is in Utah.[184]

14. Virginia. Virginia taxes the income of a resident trust, the definition of which includes a trust with a Virginia trustee.[185]

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[179] Mo. Rev. Stat. § 143.341. et seq.

[180] N. H. Rev. Stat. § 77.10.

[181] Ohio Rev. Code Ann. § 5747.01 et. seq.

[182] R. I. Gen. Laws § 44-30-2, et. seq.

[183] Tenn. Code § 67-2-110(a)

[184] Utah Code Ann. § 59-10-2-1 et seq.

[185] Va. Code § 58.1-302

15. West Virginia. West Virginia taxes the income of a testamentary trust created by the will of a West Virginia resident and an inter vivos trust created by a West Virginia resident.

16. Wyoming. Wyoming does not tax the income of a trust.

U. Estate and Gift Tax Consequences of Domestic Asset Protection Trusts.

1. Several commentators have taken the position that if creditors cannot reach the trust property, as will be the case if the Domestic Asset Protection Trust statutes prove effective, the trust property will not be includible in the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust.[186] Instead, a completed gift will occur upon the transfer of the property to the Domestic Protection Trust. The result is a freeze transaction. The settlor would incur gift tax upon funding of the trust and would continue to enjoy the property as a discretionary beneficiary of the trust; however, the trust would not be taxed in the settlor's estate under either Internal Revenue Code sections 2036(a)(1) or 2038.

EXAMPLE: A creates a Domestic Protection Trust in Alaska in 2013 and funds it with $5 million. This gift escapes gift tax because it is sheltered from gift tax by A's lifetime $5 million exclusion from gift tax. A and his children are discretionary beneficiaries of the trust. Because creditors cannot reach the assets in the trust, the gift is complete. A dies in 2020 when the assets in the trust are worth $10 million. Up until the time of his death, A has been a discretionary beneficiary and received distributions from the trust. By using a Domestic Protection Trust, according to its proponents, the $5 million of appreciation after funding of the trust will escape estate taxation.

2. Gift Tax Concerns.

a. In order to obtain this favorable tax treatment, there first must be a completed gift for purposes of Internal Revenue Code section 2511. To have a completed gift, the settlor's creditors should not be able to look to the settlor's Domestic Protection Trust for payment of debts.[187] A gift should become complete when the period specified under the law of the jurisdiction for a creditor to reach the property in the trust ends.

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[186] Covey, Richard, Practical Drafting, 4891 (1997); Blattmachr, Douglas I. and Jonathan G. Blattmachr, "A New Direction in Estate Planning: North to Alaska," 123 Trusts & Estates, No. 10, 50 (September 1997).

[187] Comm'r v. Vander Weele, 254 F.2d 895 (6th Cir. 1958); Outwin v. Comm'r, 76 T.C. 153 (1981); Estate of Paxton v. Comm'r, 86 T.C. 785 (1986).

b. In a 1993 private letter ruling[188] involving an offshore trust, the IRS found that neither the settlor nor the settlor's creditors could compel distribution of the trust assets. Therefore, the gift was complete and the trust was not subject to estate tax. Later, in 1998, the IRS ruled[189] that a transfer to an Alaskan domestic protection trust in which the settlor was a discretionary beneficiary was a completed gift.

c. If a taxable gift occurs upon creation of the domestic protection trust, one question is the amount of the taxable gift. If other family members are beneficiaries, under Internal Revenue Code section 2702, the settlor's possibility of receiving trust distributions is not a qualified interest and is valued at zero. Thus, the gift to the family is the entire amount of the property transferred. In a situation in which the trustee can make distributions to both the settlor and non-family members, it is likely that the IRS would determine that the taxable gift is all of the property transferred to the trust.[190]

d. In some situations, a settlor may not want to pay gift tax, while still insulating the trust from creditors. Under the treasury regulations,[191] the settlor could retain a special testamentary power of appointment to descendants, provided that the trustee's discretionary powers are broad and are not limited by an ascertainable standard. In such a case, discretionary distributions to other beneficiaries should be treated as completed taxable gifts in the year in which made, and should qualify for the gift tax annual exclusion.[192] Each statute envisions the settlor retaining such interests while still accomplishing the creditor protector goal.

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[188] PLR 9332006.

[189] PLR 9837007.

[190] See, e.g., Rev. Rul. 76-491, 1976-2 C.B. 301. In this ruling, which was made under Section 2512 and not under Section 2702, the IRS determined that the full value of property conveyed to a trust in exchange for an annuity is a gift where the donor's adult child had a power of appointment, exercisable at any time, over the trust property, and the trustee could not look to any property other than trust property for payment of the annuity and had no liability in the event trust property was insufficient to make an annuity payment. Under these circumstances the annuity had no fair market value.

[191] 26 C.F.R. § 25.2511-2(b).

[192] 26 C.F.R. § 25.2511-2(f).

3. Estate Tax Concerns.

a. Both sections 2036 and 2038 of the Internal Revenue Code deal with retained powers and enjoyment of the trust assets. These retained powers or enjoyment will exist when a creditor can reach the assets in a trust.[193] However, the settlor will be deemed to have relinquished his powers and enjoyment when the gift is complete (assuming that the gift to a Domestic Protection Trust is ever complete). This, in the eyes of many commentators, should keep the assets out of the settlor's estate.[194]

b. Several cases and rulings appear to support the estate tax result as shown in the following chart. The commentary, which is partially based on the thoughts of Professor Pennell, presents some criticisms of the rulings and cases, which might, if applied, eliminate the present favorable tax consequences.

Case or Ruling[195]	Decision	Comments[196]
1. Rev. Rul. 77-378, 1977-2 C.B. 347	Settlor transferred half of his income-producing assets to an irrevocable trust with a corporate trustee who could pay income and principal in his absolute discretion to the settlor during his lifetime. IRS ruled that the transfer was incomplete for gift tax purposes.	1. Reaches expected result since creditors can reach the property.

[193] 26 C.F.R. § 20.236-1(b)(2); Estate of Uhl v. Comm'r, 241 F.2d 867 (7th Cir. 1959); Estate of Paxton, 86 T.C. 785 (1986).

[194] See e.g., Kartiganer, Joseph, Pamela L. Rollins and Abraham D. Piontnica, "Completed Gifts to Offshore Trusts and the Three-Year Rule, Journal of Asset Protection 19 (March/April 1996) (hereinafter "Kartiganer").

[195] Some of these cases and rulings are cited in the order in which they appear in Blattmachr, Jonathan G and Howard M. Zaritsky, "Made in the U.S.A. - Estate Planning with Alaska Trusts," 32d Annual Philip E. Heckerling Institute on Estate Planning, Special Session Materials, II-B-17, (1998) (hereinafter "Blattmachr and Zaritsky").

[196] Some of this commentary is based on Pennell, Jeffrey N., "Recent Wealth Transfer Tax Developments," Nineteenth Annual Duke Estate Planning Conference, § 4.3 (October 1997) (hereinafter "Pennell").

Case or Ruling[195]	Decision	Comments[196]
2. Rev. Rul. 76-103, 1976-2 C.B. 293	Settlor created a trust for the benefit of himself and his family. Trustee had absolute discretion to distribute income to the settlor and to change the trust situs. IRS ruled that a gift is complete for federal estate tax purposes when creditors cannot reach the trust assets. In dicta IRS said that Internal Revenue Code section 2038 would apply if settlor dies before gift becomes complete.	1. Examined gift tax consequences but was not focused on estate tax consequences. 2. Estate tax discussion of Internal Revenue Code section 2038 is dicta and there is no discussion of inclusion under Internal Revenue Code section 2036 because settlor had access to income only.
3. Paolozzi v. Comm'r, 22 T.C. 182 (1954)	Settlor created an irrevocable Massachusetts trust to pay as much of net income as the trustee, in its absolute discretion, deemed best. IRS argued for a completed gift. Court held that right of settlor's creditors to reach the income of the trust made the gift incomplete.	1. This is a gift tax case and not an estate tax case. It does not address inclusion under Internal Revenue Code section 2038(a)(1) when there are no creditors' rights.
4. Outwin v. Comm'r, 76 T.C. 153 (1981), acq. 1981-2 C.B. 1	Transfer to trust in which the trustee, with the approval of an adverse party, could distribute income and principal was not a completed gift because settlor's creditors could reach the trust funds. Court discussed, in a footnote, the possibility that creditors' ability to reach assets could cause inclusion under either Internal Revenue Code sections 2036(a)(1) or 2038.	1. This is a gift tax case and not an estate tax case. 2. Estate tax inclusion only addressed in a footnote.

Case or Ruling[195]	Decision	Comments[196]
5. Estate of German v. Comm'r, 7 Ct. Cl. 641 (Ct. Cl 1985)	Settlor created irrevocable trusts under Maryland law and named himself a discretionary beneficiary of income and principal, with the consent of an adverse party. No gift tax was paid upon creation and the trust was not included on the settlor's estate tax return. The court denied the government's summary judgment motion that the assets should be included in the estate.	1. This was a gift tax case and not an estate tax case. 2. Government failed to establish whether creditors could reach the settlor's interest. 3. Settlor's estate conceded that it owed gift tax on creation. 4. Does not address issue of inclusion if creditors cannot reach the assets in the trust.
6. Estate of Paxton v. Comm'r, 86 T.C. 785 (1986)	Settlor transferred all his assets to a "constitutional trust" on which no gift tax was paid upon creation and no estate tax was paid at settlor's death. Court held that the trust property was included in the settlor's gross estate, under Internal Revenue Code section 2036(a)(1), because of (1) an implied understanding that the settlor could receive income or principal upon request and (2) the ability of the settlor's creditors to compel distributions.	1. Internal Revenue Code section 2036(a)(1) does not apply to a retained right to corpus. 2. Case could have been argued under Internal Revenue Code section 2038 as a power to terminate trust by relegating it to creditors. 3. Does not address issue of inclusion if creditors cannot reach the trust.
7. Herzog v. Comm'r, 116 F.2d 591 (2d Cir. 1941)	Second Circuit held that creditors could not reach assets under a precursor of Internal Revenue Code section 2036(a)(1) where settlor was an income beneficiary with wife and, after wife's death, with his children. This was because of multiple beneficiaries and trustee's discretion.	1. New York law changed after this decision, meaning that it may no longer be reliable as precedent.

Case or Ruling[195]	Decision	Comments[196]
8. Uhl v. United States, 241 F.2d 867 (7th Cir. 1957)	In an Indiana trust, the settlor received right to $100 per month and additional amounts in the trustee's discretion. Court held that a trust was not includible in the settlor's gross estate beyond the amount necessary to produce $100 per month since creditors, under Indiana law, could not reach those additional funds. Gift tax was paid on excess principal.	1. Accepts idea that estate tax and gift tax should be consistent. (which most courts reject). 2. Government failed to prove rights of creditors under Indiana law. 3. Court failed to equate rights of creditors with enjoyment of the property by the settlor, which could argue for inclusion.
9. Estate of Wells v. Comm'r, T.C. Memo 1981-574 (1981)	Settlor could receive income and principal of an irrevocable trust in the trustee's absolute discretion. No income was actually paid. Court excluded the assets from the settlor's estate because the taxpayer was able to show that there was no understanding that the trustee would actually pay the income to the settlor. Thus, there was no inclusion under Internal Revenue Code section 2036 because the settlor had not retained a right.	1. Never addressed the creditors' rights issue. 2. Decedent used the $30,000 lifetime exemption to avoid gift tax. 3. Government failed to argue that the decedent retained all of the income for life and thereby causes inclusion under Internal Revenue Code section 2036(a)(1). Mere receipt of all income does not show retention (which is shown by an agreement).
10. Vander Weele v. Comm'r, 27 T.C. 340, acq. Rev. Rul. 62-13, 1962-1 C.B. 181.	Settlor created an irrevocable trust in Michigan and authorized payment of as much of the income and principal as trustees deemed appropriate for the settlor's comfort. The court held that the transfer was incomplete for gift tax purposes since creditors could reach the assets.	1. This was a gift tax case and did not discuss estate tax inclusion.

Case or Ruling[195]	Decision	Comments[196]
11. PLR 9332006	Relying on Rev. Rul. 76-103, the IRS held that, in an off-shore trust, the trustee's ability to make discretionary distributions to the settlor and other family members was a completed gift and not a retained interest because, under the law governing the trust, creditors could not attack the trust assets.	1. May carry holding of Rev. Rul. 76-103 too far since that ruling did not conclude that Internal Revenue Code section 2036 did not apply and the discussion of Internal Revenue Code section 2038 is dicta. 2. Government may have wanted to impose gift tax because of risk of inability to collect estate tax from offshore trust.
12. PLR 8037116	Nonresident alien created irrevocable trust with discretionary income and principal provisions. Relied on Uhl and Herzog to conclude that Internal Revenue Code Section 2036 (a)(1) was not applicable.	1. Unclear whether Uhl and Herzog are good precedent.
13. PLR 9837007	Transfer to Alaskan trust in which settlor is a discretionary beneficiary is a completed gift. However, IRS specifically declined to rule if the trust property would be excluded from the testator's estate.	1. IRS obviously does not want to address estate exclusion issue.

4. Arguments for Estate Tax Inclusion.

a. If one assumes that creditors cannot reach the trust, will the mere right of the settlor to receive discretionary distributions of income and principal cause inclusion under Internal Revenue Code section 2036 (a)(1). Pennell believes that the creditor's rights test may now lack validity because of the enactment of the different Domestic Protection Trust Acts.[197]

[197] Pennell, § 4.3 (October 1997).

b. The estate tax and gift tax do not always interrelate. Even if a gift tax is paid, it is possible that property in a trust will be included in a settlor's estate because of a retained interest at later date, subject to a credit for any gift tax paid under Internal Revenue Code section 2012. Internal Revenue Code sections 2035 and 2038 may require inclusion of the trust assets in the settlor's gross estate for a period of three years after the statutory period during which creditors can reach the assets of the Domestic Asset Protection Trust.[198] This assumes that subsequent creditors can reach the property under the law of a domestic asset protection trust state. If a creditor with a right arising after the creation of the trust has his right extinguished when the statute of limitations expires, then that could be the same as a settlor releasing a retained right over the trust. This is probably a difficult threshold to cross. This assumes that any Internal Revenue Code sections 2036 and 2038 rights are extinguished when the rights of creditors to reach trust assets end.[199]

5. Conclusions.

a. The use of an estate freeze may be possible with a Domestic Asset Protection Trust. There is a great deal of uncertainty about this, however, and any attempt to do a freeze will likely invite IRS scrutiny. Moreover, if the IRS loses in court, it may seek remedial legislation that would permit Internal Revenue Code section 2036 inclusion merely if a settlor was a discretionary beneficiary of the trust. Of course, those settlors who establish domestic protection trusts prior to the date of any such remedial legislation will presumably be grandfathered.

b. For clients who are comfortable with risk, the freeze technique may be appropriate. The client must be comfortable with gift tax liability and loss of basis step up for appreciated assets transferred to the trust. One could minimize exposure to tax by: (i) use of the gift tax applicable exclusion, or (ii) using Crummey powers to qualify gifts to the trust for the annual exclusion. This is especially true because of the possible repeal of the estate tax. Most individuals will be disinclined to pay gift tax if property can be transferred free of tax at the individual's death.

c. If an estate freeze is possible, one could presumably establish an irrevocable perpetuities trust under the law of a domestic asset

[198] For more discussion of this in an off shore context, see, Kartiganer, 21.

[199] White v. United States, 881 F. Supp 688 (D. Mass. 1995); PLR 91 27008.

protection trust state with a perpetual life and have the settlor be a discretionary beneficiary. To avoid gift tax, it should be funded with no more than the donor's applicable gift tax exclusion amount. For very wealthy clients, the retention of a right to be a discretionary beneficiary will not be important. They can make gifts without worry about future access to the property. This technique works best for those moderately wealthy clients who would like to get property out of the hands of creditors and can afford to make gifts, but still have possible access to the property in the future.

d. If a settlor wishes to fund a domestic asset protection trust with an amount greater than the gift tax applicable exclusion amount, the settlor should consider creating two separate trusts. The first would be funded with $5 million (indexed for inflation) and would escape estate taxation at the settlor's death. The second would be funded with the excess over $5 million (indexed for inflation). The settlor will be given a testamentary special power of appointment which makes the gift incomplete and will cause the property in the second trust to be included in the settlor's estate. If distributions are made to beneficiaries other than the settlor during the settlor's life from the second trust, these will be treated as gifts by the settlor to the other beneficiaries. These gifts, if the distributions are outright, should qualify for the gift tax annual exclusion, currently $14,000.

V. Federal Income Tax Consequences of Domestic Asset Protection Trusts. For income tax purposes, under Internal Revenue Code section 677, a domestic asset protection trust should be treated as a grantor trust, if either the grantor or spouse is a discretionary beneficiary of income. Internal Revenue Code section 677(a) states that a grantor owns for income tax purposes any portion of a trust that can be distributed to the grantor, regardless of whether it is actually distributed. If the grantor does not want to be taxed on income he or she does not receive, the trust could require consent of a beneficiary with a substantial adverse interest in the payment of the income, such as a vested remainder person. Payment of the income tax by way of a deliberately "defective" grantor trust is actually a way to make additional gifts to the beneficiaries of the trust.

W. Impact of Bankruptcy Abuse and Consumer Protection Act of 2005.

1. The recent revisions to the federal bankruptcy code have reduced the effectiveness of certain techniques. With respect to homestead exemptions, the revisions have put time limits on residency in order for a particular state's homestead exemption to be effective.

2. The new provisions have also created uncertainty with respect to self-settled spendthrift trusts under which a settlor, if the trust meets certain

requirements, can be a beneficiary and enjoy spendthrift protection. Under the new law, if a debtor declares bankruptcy within ten years of creating a self-settled spendthrift trust, the bankruptcy trustee can void the trust if the debtor "made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted." (11 U.S.C. 548(e)(1)(A). Although the purpose of the legislation appears to have been aimed at so-called "corporate criminals," the legislation is not limited to those specific instances. Thus, the scope of the legislation will undoubtedly be litigated in the future. For example, there will certainly be litigation over whether a transfer to a self-settled spendthrift trust was made with "actual intent" to defraud, if the ten-year period has yet to end.

3. For individuals interested in self-settled trusts, the new legislation may encourage them to create such trusts sooner rather than later in order to avoid the impact of the ten-year rule.

4. Moreover, the rule only applies if the settlor declares bankruptcy, which can occur either voluntarily or involuntarily. If an individual has a self-settled trust, he or she may examine ways in which to avoid a bankruptcy filing if that ever becomes a possibility and the ten-year period has yet to end.

X. Battley v. Mortensen.

1. While estate planning professionals have been advocating the use of self-settled Domestic Asset Protection Trusts as both an asset protection tool and an estate planning tool, there has been little case law on the issue sufficient to give comfort to an individual contemplating such a trust that he would receive protection if challenged by a creditor. The May 26, 2011 ruling in Battley v. Mortensen[200] from the Alaska Bankruptcy Court, upon first review, provides little in the way of comfort for individuals hoping to protect assets using a Domestic Asset Protection Trust and their advisors. However, this case was probably a matter of bad facts producing an unsurprising result.

2. In Battley, an Alaska Geologist named Tom Mortensen transferred 1.25 acres of land located near Seldovia, Alaska, valued at approximately $60,000, to the "Mortensen Seldovia Trust (An Alaska Asset Protection Trust)," in February 2005.[201] Mortensen named himself and his descendants as beneficiaries. Mortensen had heard about Alaska's asset

[200] Battley v. Mortensen, Adv. No. A09–90036–DMD, 2011 WL 5025249 (May 26, 2011 Bkrtcy.D.Alaska)

[201] See id. at *2.

protection trust rules in casual conversation, researched the topic, and then created the trust using a template he had found. Mortensen named his brother and a personal friend as trustees and his mother as trust protector. Mortensen then had the trust document reviewed by an attorney, who appears to have suggested only minor changes. The trust instrument stated that its purpose was "to maximize the protection of the trust estate or estates from creditors' claims of the grantor or any beneficiary and to minimize all wealth transfer taxes." As required by the Alaska statute authorizing Domestic Asset Protection Trusts, Mortensen signed an affidavit representing that he was the owner of the property being placed into trust, was financially solvent, had no intention to defraud creditors by creating the trust, and the trust property was not derived from unlawful activities.[202]

3. At the time he funded the trust, Mortensen had approximately $29,881 in his bank accounts, $9,339 in business accounts receivable, and two modest vehicles. His mother sent him $100,000 after he established the trust, bringing his total assets outside of the trust to $153,000. At that time, he owed $49,711 in credit card debt and he had no other debts. There was, at that time, no litigation against the grantor pending or threatened. Mortensen transferred to the trust about $80,000 of the money from his mother. Thereafter, his credit card debt increased significantly.

4. Over four years after creating the trust, Mortensen filed a Chapter 7 bankruptcy petition in August 2009. At the time of his bankruptcy petition, his credit card debt had ballooned to over $250,000 and he had an additional $8,140 in medical debt.[203] The Chapter 7 bankruptcy trustee, Kenneth Battley, initiated an adversary proceeding to set aside the trust as a fraudulent conveyance and seeking the Seldovia property that had been placed in the trust on the grounds that the trust's spendthrift protection was invalid because Mortensen was actually financially insolvent at the time he signed the affidavit attesting to his solvency.

5. Although the Mortensen Seldovia Trust was well "seasoned" at the time of the bankruptcy filing because Alaska's four-year statute of limitations was satisfied in early 2009, the judge looking at the trust applied the statute of limitations set forth in the 2005 revisions to the bankruptcy code, which extended the statute of limitations to a full decade in cases where the transfer seems motivated by an attempt to avoid debt.

6. The bankruptcy judge ruled that Bankruptcy Code Section 548(e) allowed the court to void the transfer of property to an Alaska asset protection trust

[202] See id. (citing Alaska Stat. § 34.40.110(j)).

[203] See id. at *4.

because the trust itself was created with the intent to hinder, delay or defraud future creditors. Section 548(e) provides that in addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the bankruptcy petition, if such transfer was made to a self-settled trust by the debtor and the debtor is a beneficiary of the trust.

7. Bankruptcy Code Section 548(e) provides:

(e) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—

(1) such transfer was made to a self-settled trust or similar device;

(2) such transfer was by the debtor;

(3) the debtor is a beneficiary of such trust or similar device; and

(4) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.[204]

8. Mortensen's trust clearly satisfied the first three requirements for avoidance under Section 548(e), and the court focused on whether there was an "actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted." Mortensen claimed that his intent was "to preserve the property for his children," but the court noted that the trust itself stated that its purpose was to frustrate the claims of future creditors. The court also noted that Mortensen created the trust after several years of below-average income, high credit card debt, and "financial carnage" from a divorce.[205] The court further noted that Mortensen did not use the $100,000 he received from his mother to pay off his debts, but rather to

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[204] This provision of the Bankruptcy Act was added by the Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, § 1042, 109th Cong., 1st Sess. (2005), 119 Stat 23, purportedly to "close. . . the self-settled trusts loophole" and to "provide the estate representative with an extended reachback period for certain types of transfers." 5 COLLIER ON BANKRUPTCY ¶ 548.10[1], [3][a] n. 6 (N. Alan Resnick & Henry J. Sommer eds., 16th ed.).

[205] See Mortensen, 2011 WL 5025249 at *7.

speculate in the stock market on behalf of the trust. The court also used this stock speculation on behalf of the trust as evidence that the trust was not created merely to preserve the Seldovia property for Mortensen's children.

9. In reaching its decision to set aside the transfer of the Seldovia property to the trust, the Court noted:

> The bottom line for Mr. Mortensen is that he attempted a clever but fundamentally flawed scheme to avoid exposure to his creditors. When he created the trust in 2005, he failed to recognize the danger posed by the Bankruptcy Abuse Protection and Consumer Protection Act, which was enacted later that year. Mortensen will now pay the price for his actions. His transfer of the Seldovia property to the Mortensen Seldovia Trust will be avoided.[206]

10. The unfavorable ruling in Mortensen seems more a result of bad facts than bad law. Given Mortensen's financial situation at the time when he created the trust and transferred all of his assets to it, it was fairly clear that he was using the trust to protect his assets from claims of creditors.

11. While the case serves as precedent for other states that allow Domestic Asset Protections Trusts as asset protection tools, Mortensen's precedential value is limited to cases arising in the bankruptcy context. Indeed, the case can, and probably should, be read to provide only that in bankruptcy matters, the statute of limitations for self-settled spendthrift trusts is 10 years under Section 548(e) of the Bankruptcy Code. Even in these situations, each individual case will require a fact-specific inquiry into whether the settlor of the trust had the requisite fraudulent intent before a determination can be made whether to avoid the transfer of assets to a trust.

12. The Mortensen opinion does not negate the utility of all self-settled spendthrift trusts in Alaska or any of the other states that permit them. In Mortensen, the court focused on the fact-specific issue of intent to defraud current or future creditors. In this regard, the stated purpose of the Mortensen Seldovia Trust "to maximize the protection of the trust estate or estates from creditors' claims of the grantor" was clearly a relevant factor. If the Alaska Bankruptcy Court had different facts before it and focused on the current use of the grantor's applicable exclusion amount, the preservation of trust assets for future generations, the use of professional asset management, and other similar estate planning goals, the court might have reached a different outcome. Mortensen also provides an incentive to those individuals who wish to create Domestic

[206] Id. at *8.

Asset Protection Trusts to do so sooner rather than later in order to start the ten year bankruptcy statute of limitations for claims as soon as possible. Also, to the extent that it can be done, individuals who establish Domestic Asset Protection Trusts should avoid declaring bankruptcy. In any event, Domestic Asset Protection Trusts remain a powerful tool for individuals looking to protect themselves and their families from potential future claims and enhance their estate planning.

IX. CONFLICT-OF-LAWS PRINCIPLES RELATING TO ASSET PROTECTION TRUSTS

A. Potential Conflict of Laws. Since most states do not permit self-settled spendthrift trusts, there exists a potential conflict-of-laws issue when a settlor from one of these states creates a self-settled spendthrift trust in a state that does authorize such trusts. A conflict of laws exists when the application of the laws of different jurisdictions would not result in the same resolution.[207] When a settlor transfers assets into a self-settled spendthrift trust, and a creditor later seeks to reach those funds, two basic conflict-of-laws issues may arise. First, there is the question of what state's law should be applied to determine whether the asset transfer was fraudulent. Second, assuming the asset transfer was not fraudulent, there is the further issue of what state's law should be applied to determine whether the spendthrift trust itself is valid.[208]

B. Choices-of-Law Provisions.

1. The states with domestic asset protection statutes (collectively, "asset protection states"), as well as the other states, seek to compel the application of their own state's law to any creditors' challenges to the self-settled spendthrift trusts that these statutes authorize.

2. Conflict-of-Laws Principles Governing Trusts Under the Restatement. The majority of states have adopted the Restatement (Second) of Conflict of Laws (the "Restatement").[209] The general rules contained in the Restatement focus on the significance of a state's contacts to the trust and on the settlor's intention concerning the law that should govern the trust. Conflict-of laws principles relating to trusts are contained in Chapter 10 of the Restatement. The introductory note to Chapter 10 states that "[t]he

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[207] See Meaghan R. Hogan, Once More unto the Breach: Planning for a Conflict of Laws with Alaska and Delaware Self-Settled Spendthrift Trusts, 14-APR Prob. & Prop. 27, 28 (2000).

[208] See Stewart E. Sterk, Asset Protection Trusts: Trust Law's Race to the Bottom?, 85 Cornell L. Rev. 1035, 1075 (2000); Karen Gebbia-Pinetti, As Certain as Debt and Taxes: Estate Planning, Asset-Protection Trusts, and Conflicting State Law, SC60 A.L.I.-A.B.A. 179, 237 (1998).

[209] See Hogan, supra, at 30.

chief purpose of making decisions as to the applicable law is to carry out the intention of the [settlor]. It is important that his intention . . . not be defeated, unless this is required by the policy of a state which has such an interest in defeating his intention, as to the particular issue involved, that its local law should be applied."

C. Issues Relating to Validity.

1. Real Property Trusts. The law that would be applied by the courts of the situs determines the validity of a trust of an interest in land.[210] In most situations the courts of the state of the situs will apply its local law.[211]

2. Personal Property Trusts. An inter vivos trust holding movables is valid if it is valid under the local law of the state that the settlor designates to govern the validity of the trust, provided that this state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship.[212]

3. In re Huber (2013).[213]

a. The adverse result in Battley, discussed above, may have been a factor of missteps by the debtor: in that case, an insolvent debtor creating a self-settled asset protection trust, then filed for bankruptcy after the four-year lookback period under Alaska law, but within the ten-year statute of limitations period under federal bankruptcy law.

b. However, the result in In re Huber casts more doubt on the validity of self-settled asset protection trusts in states whose own laws do not recognize them.

c. In In re Huber, the debtor had been a real estate developer for over 40 years.[214] On August 19, 2008, shortly after the collapse of the real estate market in 2008, the debtor established a trust to shield

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210 See Restatement (Second) of Conflict of Laws § 278 (1971).

211 See id. at § 278, cmt. a.

212 See id. at § 270.

213 In re Huber, Adv. No. 12-04171, 2013 WL 2154218 (Bkrtcy. W.D.Wash. May 17, 2013).

214 Id. at *1.

his assets, with what the Court considered "urgency in setting up the Trust."[215]

d. The bankruptcy trustee moved for summary judgment to invalidate the trust and to prevent discharge on the part of the debtor. The Court invalidated the trust on two independent grounds, but the Court held that the evidence was not sufficient to deny discharge, so the Court denied the motion for summary judgment on that issue.[216]

e. The debtor transferred practically all of his assets to the trust, which continued to hold those assets in Washington. The debtor opened a $10,000 certificate of deposit in Alaska. The Court noted that when the debtor funded the trust in August 2008, several of his loans were "fragile at best."[217]

f. The debtor filed for bankruptcy three years later, on February 10, 2011—one month before the opinion in Battley was handed down.

g. The Court applied the principles of the Restatement, cited above, and reasoned that the court would follow the trust's choice-of-law selection of Alaska law if Alaska had "a substantial relation to the trust" and if application of Alaska law would not violate a strong public policy of Washington's.[218]

h. The Court held that Washington law would apply to the issue of the validity of the trust.

(1) The Court concluded that the trust had only a "minimal" relation to Alaska, and instead had a "substantial relation" to Washington: the debtor resided in Washington, and all trust assets but the $10,000 certificate of deposit were located in Washington.[219]

(2) But the Court further concluded that enforcing the trust would violate a strong public policy of Washington's. Washington law would not enforce a self-settled asset

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[215] Id. at *3.

[216] Id. at *14–16.

[217] See id. at *2–3.

[218] Id. at *7.

[219] Id.

protection trust against existing or future creditors, even without a showing of intent to defraud the creditors.

i. Because the Court held that Washington law would apply to the validity of the trust, it was then a foregone conclusion that Washington law, when applied to the trust, would invalidate the trust.[220]

j. Despite the fact that the Court had invalidated the trust, the Court went on to rule that the transfer was void under the Bankruptcy Code, as a fraudulent transfer under § 548(e).[221] Just as in Battley, the Court noted that the debtor had "significant indebtedness" and "substantial financial problems" at the time of the transfer; although the Court did not find that he was insolvent, the Court noted that the debtor was unable to pay certain bills, had sold some of his properties to pay his debts, and had unsuccessfully attempted to raise funds.[222]

PRACTICE TIP: As was one of the key lessons in Battley, the settlor should establish the asset protection trust not only before he is insolvent, but even long before his debts appear "fragile".

PRACTICE TIP: But setting up such a trust well in advance of financial trouble is not sufficient under In re Huber. Notably, the court in In re Huber did not require any fraudulent conduct on the part of the debtor; instead, the Court only looked to which state's law would govern the validity of the trust. In order to make a court more likely to apply the law that would uphold the trust, the debtor should move the trust assets to that jurisdiction; at $10,000 certificate of deposit in Alaska was insufficient to shelter those assets.

PRACTICE TIP: But even moving the assets of the trust to a state which enforces such trusts may not be enough. In In re Huber, the Court noted that enforcing a self-settled asset protection trust would violate a strong public policy of Washington's; the Court did not explain whether a violation of such a public policy, regardless of the substantial relationship to that state, would be enough to invalidate the trust.

[220] Id. *7–8.

[221] Id. *9

[222] Id. *10.

D. A Challenge based on Fraudulent Conveyance.

1. Assuming that the forum court will reject the settlor's choice-of-law in a fraudulent transfer claim, commentators have concluded that the court will most likely apply the law of the state that has the most significant relation to the issue of whether the asset transfer to the trust is voidable under fraudulent transfer law.[223]

2. The Restatement sets out the following factors that are used to determine the jurisdiction with the most significant relationship to the contract: (i) the place of contracting; (ii) the place of contract negotiation; (iii) the place of performance; (iv) the location of the contract's subject matter; and (v) the domicile, residence, nationality, place of incorporation, and place of business of the parties.[224]

3. It may be likely that the home state of a settlor who does not reside in an asset protection state will be the jurisdiction with the most significant relationship to the contract.[225] In any event, the critical issue for settlors of asset protection trusts is that the forum court is not bound to apply the law that the settlor has chosen.[226]

4. In this inquiry, the inquiry of which law applies may not be as important as the facts. In In re Huber, the court summarily determined that Washington law would apply in an action to invalidate the transfer based on fraudulent conveyance. But in that case, the court applied Washington's version of the Uniform Fraudulent Transfer Act, discussed above, which, in turn, evaluated the "badges of fraud" present in the underlying transaction.

E. Another question is whether the courts of a domestic asset protection trust state would enforce the judgment of another state, not against the settlor, but against the trustee and the trust assets.

1. In In re Huber, this practical problem may not arise; in that case, the debtor owned only a $10,000 certificate of deposit in Washington, and the majority of the assets held in trust were located in Washington, not Alaska.

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[223] See Gebbia-Pinetti, supra, at 250; Veit, supra, at 285-86.

[224] See Restatement § 188.

[225] See Veit, supra, at 291.

[226] See Gebbia-Pinetti, supra, at 251.

2. However, in a future case in which a settlor finds his or her self-settled trust invalidated under a given state's law as against public policy, a settlor with substantial assets in a friendly jurisdiction may find this as the last line of defense.

X. PRACTICAL PROBLEMS WITH RESPECT TO DOMESTIC ASSET PROTECTION TRUSTS

A. Enforceability of Foreign Judgments.[227]

1. One often-repeated advantage of foreign asset protection trusts is the fact that in most applicable jurisdictions, local law specifically prohibits the automatic enforcement of foreign judgments. In the Cook Islands, for example, a judgment of a Non-Cook Islands court has no legal significance. As a result, the underlying cause of action must itself be relitigated in the foreign jurisdiction. Such re-litigation is impeded by such circumstances as the unavailability of witnesses, the "loser pays" fee environment and the lack of local legal talent. This impediment does not exist in the case of the onshore domestic protection trusts given the requirement under the United States Constitution that each state give "full faith and credit" to judgments handed down by courts in all of the states. Accordingly, once the creditor reduces a claim to judgment in any United States court, there is no need to relitigate the underlying cause of action in the state where assets are held in trust. In effect, the successful creditor will bring an action to enforce the judgment with respect to the assets in the onshore domestic protection trust, either in the state where the creditor and debtor reside (typically the same jurisdiction of the underlying judgment) or in the state where the trust has its situs.

2. Enforcement of Judgment in Original Forum.

a. With respect to an enforcement action brought in the original forum or elsewhere other than where the trust has its situs, Giordani and Osborne suggest that the courts may ignore the law of the trust situs and apply their own "self-settled" trust rules; in such a case, the judgment being taken to a domestic asset protection trust state for enforcement is not the underlying judgment on the dispute between the parties but a judgment requiring that the trust assets be turned over to the creditor. Although this result may obtain, it runs contrary to the general rule that the law governing the interpretation of a trust is the law of the

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[227] Most of the many articles addressing the Domestic Protection Trust laws consider this issue. A detailed analysis of the Alaska and Delaware laws is contained in Giordani, Leslie C. and Duncan E. Osborne, "Will the Alaska Trusts Work?", Journal of Asset Protection (September/October 1997).

trust's situs. In The Law of Trusts, Professors Scott and Fratcher include a lengthy analysis of these conflicts issues. In pertinent point, they indicate:

> Where the settlor creates a trust to be administered in the state of his domicile, the law of that state is applicable in determining whether the interest of a beneficiary can be reached by his creditors. This is clearly so where a proceeding is brought by a creditor in that state. It would seem that the same principle would apply where a proceeding is brought in some other state to reach the beneficiary's interest. The court, if it has jurisdiction and chooses to exercise it, will apply the law of the state of the situs of the trust.
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> If the settlor creates a trust to be administered in a state other than that of his domicile, the law of the state of the place of administration, rather than of his domicile, ordinarily is applicable.[228]

b. Although this discussion pertains to third-party beneficiaries, it is equally applicable to the domestic asset protection trust state situations where the self-settled trust rule is replaced for certain settlor-beneficiaries. Accordingly, although it is possible that the original jurisdiction will apply its own self-settled trust rules in support of its own public policy, such a decision would itself run contrary to long-standing conflict principles and should not be relied on by a creditor seeking to enforce a judgment without additional precedent.

3. Enforcement in Jurisdiction Where the Trust Has Its Situs.

a. More typically, the creditor will bring an enforcement action in the state where the trust has its situs, and the creditor will then be required to rely on the domestic asset protection trust states themselves for relief. This would include the applicable fraudulent conveyance laws of those states as well as the exceptions contained in the statutes themselves.

b. Although the domestic asset protection trust states have chosen to adopt laws that run contrary to the centuries-old traditions embodied in the Statute of Elizabeth, it is quite possible that the courts in those states will construe those laws strictly (and thus in a creditor friendly manner) to avoid the appearance that those states have somehow removed themselves from the mainstream of

[228] Scott and Fratcher, The Law of Trusts (4th ed, 1989) § 626(2).

American legal doctrine. Instructive in this regard is the widely reported decision of the High Court of the Cook Islands in 515 Orange Grove Owners Association v. Orange Grove Partners.[229] The interlocutory nature of the proceeding coupled with the apparent settlement of the case prior to a substantive hearing make it difficult, if not impossible, to derive meaningful guidance from the case; however, the amount of commentary on the decision reflects the fact that some believe that the High Court has taken a stand against the use of Cook Islands "International Trusts" to encourage fraud and deceit, while others believe that the High Court was simply wrong in its decision.

c. It can be said that the High Court expressed itself in dicta that it would not sanction abusive practices in creating these trusts, and its decision was perhaps based on this philosophy. The legislature of the Cook Islands rapidly modified its governing law concerning these trusts by way of the International Trusts Amendment Act 1995-96, which became effective on November 21, 1996. That Act changed the provisions of the prior law on which the High Court based its "creditor friendly" opinion and made several other changes.[230]

B. Judgment Against Trust and Not Settlor.

1. Many commentators believe that if an enforcement action were brought only against the settlor of a trust in courts of a domestic asset protection trust state would protect the trust assets when asked to enforce the judgment of another state.

2. Another question is whether the courts of a domestic asset protection trust state would enforce the judgment of another state, not against the settlor, but against the trustee and the trust assets. Supporters of the Domestic Protection Trust Acts point to two cases to counter this.

3. In Hanson v. Denckla,[231] the U.S. Supreme Court upheld the decision of a Delaware trustee to refuse to enforce the order of a Florida court. In Hanson, a Pennsylvania resident established a trust, naming a Delaware trustee. The settlor moved to Florida, where he died. The widow attempted to exercise certain powers of appointment over the trust. The

[229] Complaint No. 208/94 (High Ct., Rarotonga, Civil Division, No. 6, 1995).

[230] The reader interested in this controversy should read two articles in the Journal of Asset Protection one by Charles Bruce and Wendy Wojewodzki in the January/February 1997 issue and the other by John McFadzien in the March/April 1997 issue.

[231] 357 U.S. 235 (1958).

children disputed the validity of the exercise of the power and the Florida court entered an order mollifying the exercise of the power. The family then went to Delaware to have the order enforced. The Delaware trustee declined, arguing that the full faith and credit clause was inapplicable since the Florida court lacked jurisdiction over both the Delaware trustee and the trust assets.

4. In Baker v. General Motors,[232] the U.S. Supreme Court held that Missouri courts were not bound to enforce a Michigan judgment prohibiting testimony from a particular witness when the parties to the Missouri action had no connection to the Michigan courts.[233]

XI. CONCLUSION

A. There is no doubt that significant assets of United States persons have been transferred to foreign jurisdictions for management and investment and that the domestic trust industry has lost the opportunity to handle this business. There is also little doubt that this trend will continue as wealthy individuals become aware of high-profile litigation results and of the opportunity to protect assets using offshore protection trusts. Importantly, very few individuals creating offshore protection trusts seem to wish to treat the creation of the trusts as a completed gift; it is the authors' understanding that virtually all such trusts are designed to be included in the settlors' estates for federal estate tax purposes. It is a logical and almost inevitable result of this environment that those interested in the domestic trust industry would search for ways to accomplish similar goals in the United States.

B. On the other hand, it is suggested that those same legislators do not wish to have their states viewed as jurisdictions which give no respect to the rights of creditors; after all, a fundamental concept of American Constitutional law is that states are to give full faith and credit to the judicial actions of courts sitting in other states. As a result, the new statutes take a different route than that of the Offshore Trusts. The starting point is the assumption that individuals wish to make completed gifts for gift and estate tax purposes but cannot do so if creditors can reach the transfers. The solution is to eliminate the creditors' rights, with the exceptions noted above.

C. At least fifteen states have local laws encouraging the creation of trusts, which may benefit the settlor while being completed gifts, and generally exempt from claims of the settlor's creditors. How will courts in other states react to the fact

[232] 118 S. Ct. 657 (1998).

[233] For more discussion of this, see, Kaleen S. Hasagawa, "Re-evaluating the Limits of the Full Faith and Credit Clause after Baker v. General Motors," 21 Univ. Hawaii Law Review 747 (1999).

that their citizens have avoided the application of long-standing local law by adopting the laws of a jurisdiction, which has a fundamentally different public policy? Will other states attempt similar statutory change? How will the "creditor community" feel about the elimination of the Statute of Elizabeth? Are fraudulent transfer rules enough? Will the Congress react by expanding the reach of Internal Revenue Code sections 2036 and/or 2038? After all, the essence of those sections of the Code is to treat as includible in the gross estate assets transferred with strings attached.

D. These and other unanswered questions will undoubtedly be the subject of much comment and perhaps judicial review in the next several years.

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