Report #5

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REPORT NO. 5 - Wednesday, 1/9/02

We haven't received a report yet on the Tuesday afternoon EGTRRA Drafting session, so, rather than holding everything else up for that, we are going ahead and reporting on the following Wednesday CLE sessions at this time, at least to the extent we have received information to report on them:

8:30 - 9:15 a.m.
Life Insurance as the Life Preserver for the Closely Held Business
Mary Ann Mancini

No materials received yet, but they are coming. In the meantime, see the **Weinberg Group** report on **IRS Notice 2002-8** that is included at the end of Report #4A.

9:15 - 10:00 a.m.
Non-Tax Considerations in the Succession of Closely Held Businesses
Charles D. (Skip) Fox IV

Skip Fox has reported the following to us on his session:

My presentation on the non-tax aspects of family business succession on Wednesday morning was not technical. The following were the major points that I tried to make:

1. Between 30% and 40% of family businesses will have a transition in leadership in the next several years. This is a considerable number since there are 20 million family businesses ranging anywhere from mom and pop stores to Fortune 500 companies.

2. 85% of the crises faced by family businesses arise from succession issues. Because of the conflict involved, however, most families attempt to ignore or fail to plan for succession.

3. Three models of business ownership can help planners advise families on succession issues:

a. Controlling owner (dictatorship) in which one person has control and makes the decisions. This is often the format at the first generation. However, many companies, such as Forbes and Beretta have used the controlling owner format for several generations

b. Sibling partnership. Two or more siblings or others have control. Sometimes there is one acknowledged leader and sometimes all have responsibilities for different aspects of the business. This is often found at the second generation.

c. Cousin consortium. Different family members from different branches and generations work in the company. This is often found at the third generation.

4. The likelihood of problems is greatest when the leadership changes from a simpler form (such as controlling owner) to a more complex form (such as sibling partnership).

5. The agreement of all the family members is necessary.

6. Even if a succession plan is in place, one critical function of the planner is to make sure the family implements the plan and watch out for signs of trouble or failing to adhere to the transition plan.

7. The succession plan should be developed first and then and only then should the planner take the steps to minimize the tax consequences. Tax considerations should not drive a succession plan. That can be a recipe for disaster.

8. The planner has to listen to all family members in order to come up with a viable succession plan.

10:00 - 10:45 a.m.
Uses of Installment Sales, Private Annuities and SCINs
Jerome M. Hesch

No report.

11:00 a.m. - 12:30 p.m.
Question & Answer Session
Dennis I. Belcher
Carol A. Harrington
Prof. Jeffrey N. Pennell

No report.

2:00 3:30 p.m.
Special Sessions I

No reports

3:45 5:15 p.m.
Special Sessions II

II-A CASE STUDY **Business Succession Planning**
Charles D. (Skip) Fox IV

See above re his Wednesday morning general session.

II-C **Asset Protection Planning: Protection vs. Control**
Gideon Rothschild

Gideon has reported the following to us on his Special Session:

My workshop on Wednesday afternoon revolved around 2 case studies focusing on asset protection.

The **first case study** dealt with the domestic solutions, including self-settled trusts in Delaware., Alaska, Nevada and Rhode Island, tenancy by the entireties, estate planning with spendthrift, discretionary trusts, and QPRTS and other split interest trusts. We discussed how the self-settled trust can be a useful tool to utilize a client's annual exclusion or lifetime exemption amount where clients aren't sure they can divest themselves of such amounts and particularly with the looming repeal (?) in 2010. These trusts can be established as completed gifts in the4 states (or offshore) and removed from the settlor's estate while the settlor can still be a discretionary beneficiary thereof in the event he/she should need access thereto. Similarly, I noted the utility of Sec. 529 plans. We also discussed special needs trusts and why planners should encourage their clients to leave their estates in trust for as long as possible with flexible provisions therein - to thwart off claims of spouses and creditors.

I noted a few recent cases wherein divorce claims and child support claims were made and where the creditor-spouse sought to receive a share of a spendthrift trust where the debtor-spouse was a beneficiary (and where the trust was settled by debtor's parents, one parent was still living, the trust could be invaded by her and revoked by her and he was merely a remainder beneficiary (yes - the court awarded the creditor spouse an interest therein) and another case where the beneficiary was also the trustee (of a trust settled by his parents) and the spouse attempted to reach it for application of his child support obligations.

The **second case study** was a discussion of foreign situs trust considerations, with discussion of a recent case (**Bank 0f Americas v. Weese**) in which the debtors (after they already defaulted on a bank loan) established a Cook Island trust and the court granted an injunction against the parties and found they had jurisdiction over the trust since the trust owned realty in the state and a co-trustee resided therein. We discussed the considerations of trustee selection, protector considerations, and fraudulent conveyance issues using a case study approach with the background of the **Weese** case and other decisions. I emphasized that if planners wish to use
foreign trusts they should ensure that they are not assisting the client in any fraudulent conveyance as it may cause them to be exposed to litigation or disciplinary action. Attorneys must engage in adequate due diligence to ensure that their clients are not intending to defraud existing or probable creditors nor looking to avoid their tax obligations.

EDITOR'S NOTE: An interesting case [***Gorman***] involving a child's remainder interest in a parent's revocable living trust for purposes of determining what portion of that trust is considered marital property that is subject to equitable division in the child's divorce proceedings was recently decided by the Colorado Court of Appeals. The decision, which is seen by most commentators as being contrary to the applicable laws, could have significant adverse ramifications for dealing with such interests in the future, even for attorneys who are not licensed to practice law in Colorado but who are drafting such trusts for parents of children who might reside in Colorado, since it was not appealed further up to the Colorado Supreme Court. It is reported here since it also could have serious implications for people doing asset protection planning for Colorado residents absent a statutory amendment to overrule or modify the holding of this case. The authors of this report are Eugene Zuspann Jr. Esq. and John DeBruyn Esq. of Denver, Colorado (Gene has been a reporter for us in prior years).

First John DeBruyn reports:

The Colorado Court of Appeals finds in Gorman, October, 2001, that a child's remainder in the parent's funded revocable trust is
property for purposes of the division of marital property in the child's divorce. Since the child's property rights were gratuitously
conferred by the parent, only the appreciation in value during the marriage will become part of the marital property to be subject to
equitable division with the child's spouse as part of their divorce. The case is at:

http://groups.yahoo.com/group/tDocs/files/gorman.html

The Court of Appeals observed: "While attempting to place a present value upon these interests may be difficult, we see no reason why it cannot be done. Further, we see no reason why the trial court, after determining the present value that is subject to division, cannot postpone the physical division of that value until the [spouse with the interest] comes into possession of the property, and make such distribution subject to its not being defeated."

We have had all those situations over the years where the estate plan with a will has worked better than a funded revocable trust for
income tax purposes. And here we have a situation where the funded revocable trusts of the parents gets their property entangled
in a child's divorce.

Certainly the parent can revoke the interest. But would the Courts, having taken us this far, with form over substance, be tempted in
the case of a revocation to nevertheless tag the eventual distribution of the parent's property via will or another trust to the child even though the trust had been revoked in the mean time.

Gene Zuspann replies to John and the closed CBA-TES list as follows:

I agree that John's Gorman case is certainly interesting.

I am not sure where the court is going in these cases. The courts seem to be going down the path that if there is any vested remainder subject to divestment or defeasance, no matter how certain or remote the condition subsequent, that the interest is marital property under 14-10-113, C.R.S. The significant question in the divorce then becomes whether a valuation of the asset should be undertaken now, or whether, as Gorman suggests, that the division of the trust assets be postponed until the beneficiary spouse comes into actual possession of the property. Talk about the mere expectancy discussed in Jones and Rosenblum!

I believe that the court is correct under Colorado law in holding that the interest of the beneficiaries is a vested remainder. This result has been reached before.

<u>See</u>
Brenner, 37 Colo App 271 (1976)
DNB v Von Brecht, 322 P.2nd 667 (Colo 1958)

Also, check out Wallis Campbell's article on future interests in Krendal, Colo Practice Methods, at 2319.

For further reference, check out the following materials.

Balanson - Colo 2001
Jones - Colo 1991
Rosenblum - Colo App 1979
In re Question submitted by the United States Court of Appeals for the Tenth Circuit, 191 Colo. 406 (Colo. 1976)

Several *Colorado Lawyer Articles* also discuss the developments:

<u>See</u>, Nancy Crow "What does *Balanson* mean to Estate Planners? - Drafting Trusts to deflect the Spousal Creditor," 30 *The Colorado Lawyer* __ (October, 2001) discussing the impact of the portion of the decision involving the family trusts;

Steve Lass and Matt Seidman, "Property or Expectancy: the Division of Trust Assets as Dissolution of Marriage," 30 *The Colorado Lawyer* 63 (February, 2001) a discussion of the appellate court opinion in *Balanson*; and

David Kirch, "Avoiding Appreciation in Trust Assets Being Treated as Marital Property," 27 *The Colorado Lawyer* 58 (March, 1998) regarding trusts to avoid having the trust considered as marital property.

Finally, the Restatement (Second) Trusts at 150 to 156, and the UTC at 501 to 506.

Also check out Scott and Bogert on trusts, and Am Jur, Trusts, and Estates.

Under Gorman, I do not believe the divorce restrictions Karen suggested work any longer. I agree this is a substance over form issue, but the law, probably both here and in the common law, seems to be that the beneficiary's interest vests at the creation of the trust.

Therefore, for the moment, and until/hopefully this gets appealed, it seems prudent to either use a will or a discretionary GST trust as used in Jones and Rosenblum.

To which John Debruyn replies, and Gene responds in place, as follows:

John, my comments are in the text below - Gene

At 10:13 AM 11/26/01 , John wrote:
>Thanks doing and sharing the research and your observations
>about vested remainder interests in the context of the definition
>and division of marital property in divorce. Your read of Gorman
>has appeal. It would be most efficient (since the interest is likely
>to be revoked, no :) to postpone the heavy lifting on the valuation
>and division process of the remainder until it matured upon the
>death of the parent as the Gorman may be suggesting.

I think that Gorman is leaving this as an option of the judge. In other words, divide all other property now, and leave the non-beneficiary spouse a percentage, to be received upon possession of the beneficiary spouse, if any still exists. This seems to be an easy solution for the judge. However, from a practical standpoint, if the parent is not incompetent, the trust will need to be amended or revoked as soon as the marriage starts. (Hey, this has potential) Now, surely, the judge cannot order that the in-law has an interest in the estate. And further, I would assume that the valuation of the interest of the child, where the parent can amend or revoke, has to be about zero.

>Let me, for the sake of discussion, take a different cut on what
>Gorman may mean here. The trial court is stuck doing some kind
>of valuation as a threashold matter just to determine whether
>there is any marital property at all--that is the appreciation during-
>the-marriage component of gift remainder property.
>
>To do that the court probably needs to determine the.acquistion
>(or if later, marriage) value of the property and the date of
>dissolution value of the property of the trust subject to the
>remainder interest.

Agreed. They probably need three numbers - basis of trust to determine income tax (a Davis issue), value at date of marriage or date of creation, to determine the separate property, and value at date of dissolution.

>The property of the trust may not even be the same at the
>beginning and ending dates. This process of determining
>appreciation in the property which is subject to an interest in trust
>creates some good questions in itself. For example, how does the
>determination of appreciation on an asset by asset basis
>(depreciation in one asset is not offset against appreciation in
>another) play out.

I am not sure this is necessary - the interest is the remainder interest in the trust, not in each asset. It seems to me that the value is the value of the whole, not of each asset.

>Without the beginning and ending valuation the trial court does not
>know whether there is any appreciation in value (of particual
>assets ?) needed to find that marital property exists. As along as
>the Court needs those values, then it may as well, efficiency in
>mind, determine quatum of the fraction that is to be marital
>property.

It should still need those values to determine the fraction. Assuming no other assets are allocated to try to compensate for the interest in the trust, the formula seems to be:

s = value of trust at time that it is separate property (either date of marriage or date of creation, whichever is later)
d = value of trust at time of divorce
p = percentage of trust that is marital property

$p = Max(0,d-s)/d$

As a check, see if you agree with the following scenarios

Number 1
s = 500
d = 750
p = 33.3%

Number 2
s = 500
d = 500
p = 0 (there is no marital property, because no appreciation between s and d)

s = 500
d = 450
p = 0% (because marital property cannot be less than zero - the max function)

After determining p, the court has to determine what portion belongs to each spouse. I assume this is normally 50% of p to each in a long term marriage.

>Then, going down this road a bit farther for the sake of discussion:
> there is the next step, how much of the marital property fraction
>is to be awarded equitable to each spouse. Perhaps the Gorman
>court, when it suggested postponement of the "division," was
>thinking that the spouses would divide the future interest in trust
>that was marital property on a fifty-fifty basis. Whether a
>particular asset (or group of assets?) should be divided one what
>or another would seem, since the division is equitable , to implicate
>the division of all of the other property.

I agree.

>If one takes the foregoing route, then the division that the Gorman
>court is postponing is just the partition of the future interest when
>it becomes a present interest between the maritial and nonmarital
>fractions and the marital fraction between the spouses.

I think maybe the Gorman court thought they were avoiding some work. The quality of the opinion certainly avoided any work. The Gorman opinion states that the father’s trust "is substantially identical to the trust involved in *Balanson*." However,

- The Gorman case does not identify the trustee, but with the powers enumerated, it is assumed that an independent trustee was used or the mother would have a general power of appointment. The father in Balanson was the sole trustee.

- Gorman said that each trust provided that no beneficiary had any interest in any of the trust property and each trust contained a spendthrift power. Balanson never addresses this issue.

- In *Balanson*, the distribution of corpus was limited to standards, but in Gorman the standard includes the spouse's welfare.

>Before I get back to some real work, here is another thought.
>
> Unter the Imel case (don't recall at the moment whether there
>are one or two Ms) the spouse of the remainder-person spouse
>has an inchoate undivided property interest in the remainder upon
>the filing of the petition for divorce. Where does that take us :)

I will have to check that one out.

To which John replies back to Gene as follows:

Thanks for threading through the argument for three different value dates assuming the Gorman suggestion of putting off the division of the remainder till the death of the parent.

I agree with your examples on the calculation of the fraction. I have not formed an opinion yet on whether the trust fund would be one property or multiple properties based on what the trustee actually held, which is important for whether gains and losses in a group of assets should be aggregated or just the gain assets taking into account.

I am wondering whether the remainders in Gorman and Balanson were subject to the condition of survivorship or not. I think most of
the forms out there use survivorship language and avoid vested remainders.
However, I got my Simes out and find that contingent

remainders are today generally alienable but that this was not always the case.

The distinction between vested vs. contingent "'nonvested" remainders is important for purposes of the rule against perpetuities. Contingent remainder's must vest within the period, subject to some recent amendments here in Colorado, if at all.

If a contingent remainder interest is alienable in Colorado, that needs some more research, is it property eligible to become marital property for purposes of the division of marital property in divorce.

- - - - - - and

Here is an up date on contingent remainders, vesting et cetera.

The opinion in In re Question Submitted by United States Court of Appeals for Tenth Circuit, 553 P.2d 382, 191 Colo. 406 (Colo.
08/23/1976) concludes:

Therefore, we answer the question certified to us by the Court of Appeals for the Tenth Circuit, viz., as follows: under Colorado law,
the interest of William Arthur Martinson (taxpayer) in the trust created in his name under his father's will, is not a future interest
subject to a condition precedent. The condition of survival is a condition subsequent. Taxpayer has a vested right to the moneys
designated for him, but that right is subject to complete defeasance in the event he does not survive the life tenant,
testator's widow.

It did not jump out at me as I read the facts whether the interest of son was in fact conditioned upon his survival of his mother whose
life estate preceded his remainder. I found the Tenth Circuit Court of Appeals case at 76-1 USTC para 9691. The provisions of the
trust did require the son to survive and provided for alternate takers in the event that he did not survive her.

To which Gene replies as follows:

The question now becomes whether I should change my drafting to avoid having a vested remainder at all, to keep the interest from being property in a divorce?

As indicated earlier, Gorman is apparently not being appealed. Gorman, along with Balanson, are going to assign some value to that property interest. The judge is going to have to decide what to do - divide the trust, with possession delayed in both spouses, or take the value into consideration in dividing up existing assets. Neither is a satisfactory situation with the client/parent.

To which John replies as follows:

The remainder interest in the CA 10 case where the Colorado Supreme Court

said the interest was vested was a contingent
remainder interest. The beneficiary had nothing unless he survived till the end of the preceding interest. If contingent remainders are
vested, then what--a gift to a purely discretionary trust with an independent trustee.

But some people are not that enamored with trusts in perpetuity and the like. Perhaps you make the gift of the residuary to the
Salvation Army subject to a retained power of appointment exercisable by will. And then exercise the power in favor of the
child by will. What have you thought about doing.

And tax attorney Nancy Crow Esq. of Denver interjects as follows:

What a wonderful, spirited discussion! I've been too bogged down with work to enter into the fray. But, since I did write about Balanson recently, I should probably put a word in.

Gorman was the logical extension of Balanson; I don't think the Court of Appeals had much choice but to come out the way it did. From the drafting perspective, the decision renders wills a better estate planning tool than revocable trusts for the parents who are truly concerned about their children's divorce proceedings. Following death, having the trust wholly discretionary is the best bet, for people who have a trusted trustee and like the idea of trusts. Parents who are concerned about spousal creditors are likely to be concerned about their children's other potential creditors, so they are generally receptive to long-term trust arrangements.

Some tougher questions revolve around disclosure and discovery. Children don't necessarily know, or have a right to know, what their parents' revocable trusts say. Parents are not parties to their children's divorce actions and discovery could be intrusive, to say the least.

From the family law viewpoint, valuation is going to be a significant problem. Modification of the definition of marital property to exclude amounts to be received in the future is one possibility, with the recognition that a contingent vested remainder could still be an "economic circumstance" to be taken into account by the court in dividing property and awarding maintenance. In any event, courts are likely to adopt a wait and see approach to these future interests, just as they have for retirement plans.

To which Gene responds to Nancy and John as follows:

I agree with everything that Nancy says, except that a rev trust with purely discretionary trustee powers after death, a la Jones and Balanson, would not be property either.

Our problem seems to one of semantics. A vested remainder subject to a condition subsequent and a contingent remainder both have conditions attached. However, the former vests subject to the event happening to divest the interest, where the latter is not vested until and unless the event occurs. The difference is whether the condition is a condition subsequent or a condition precedent.

The facts in the CA-10 case were that the remainder was vested subject to divestment by a condition subsequent. The following is the Court's headnote 4. Also, I am not sure the facts in CA-10 support the conclusion of the court.

The document provided - life estate in mom, followed by life estate in Taxpayer (T), remainder to 3 other trusts subject to whole of trust corpus paid out earlier (a condition subsequent).

I do not understand why T does not have a life estate. Especially in this case, where mom elected against the will and there would not be any distributions out of the trust for any beneficiary before the T.

4. Taxpayer - Vested Right - Moneys - Trust - Subject to Defeasance. Question certified to Supreme Court of Colorado by Court of Appeals for Tenth Circuit is answered as follows: Under Colorado law, interest of the taxpayer in the trust created in his name under his father's will is not a future interest subject to a condition precedent; the condition of survival is a condition subsequent; taxpayer has a vested right to the moneys designated for him, but that right is subject to complete defeasance in the event he does not survive the life tenant, testator's widow.

This is a property interest under the law. A contingent remainder is one subject to a condition precedent, and does not vest until the event occurs. In the case of a contingent remainder, there is no property interest.

Of course you realize, THAT THIS IS MY OPINION, WHICH COULD VERY WELL BE WRONG, but I don't believe so after reading several articles on vesting. (But I cant find any of my old hornbooks or other references which specifically address future interests). I have looked at Am Jur, Krendal and some old (30's and 40's) articles by Leach and Casner.

So my conclusions are:

Contingent remainders are not vested. See above. However, Jones and Rosenblum confirm that a purely discretionary trust is an expectancy - so this is what I prefer.

As above, I like the purely discretionary trust, but I still have some remainderman down the road - grandchildren, great-grandchildren. During the SS or the child's life, a special power of appointment could do the job. Discretionary but SS could change to a vested remainder. You could always draft these as a contingent remainder to eliminate vesting after the death of both spouses.

And (finally) John responded to Gene as follows:

I agree with your read of what the law of remainders was and should be, which was that a remainder that required survivorship of the life estate in order to take was a contingent remainder and that contingent remainder did not vest until the termination of the life
estate. I read the Colorado Supreme Court to say in their response to the CA 10 back in 1976 that a condition requiring survivorship in order to succeed to the remainder interest is not a condition precedent, contrary to all that good old stuff that you and I have

been reading elsewhere, but that such a condition is a condition subsequent.

The head note you quoted said:

> will is not a future interest subject to a condition precedent; the
> condition of survival is a condition subsequent; taxpayer has a
> vested right to the moneys designated for him, but that right is
> subject to complete defeasance in the event he does not survive
> the life tenant, testator's widow.

If I were a betting man, I would bet that the language conferring the remainder in the parent's trust on the child in both Balanson and Gorman is, more or less, "to my child, if he or she survives me" or some other tried and true phrase, which under the good old stuff that we have been reading about contingent remainders, would have been a contingent unvested remainder.

That is it for Report No. 5. The full text of all the Reports will be posted on the ABA RPPT Web site at
http://www.americanbar.org/groups/real_property_trust_estate.html.

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