COMING TO A COMMUNITY NEAR YOU

BRAC 2005 and the Transformation of America's Military

By Randall S. Beach

The first base realignment and closure (BRAC) round in a decade is occurring this year and promises to be the largest divestment ever of military base property. Despite four previous BRAC rounds in the 1980s and 1990s, the Department of Defense (DoD) remains one of the largest landowners in the world. The DoD infrastructure inventory includes approximately 586,000 buildings at more than 5,500 locations comprising more than 30 million acres. Dep't of Defense, Base Structure Report (2004), available at www.defenselink.mil/pubs/20040910_2004BaseStructureReport.pdf. The DoD has sought this latest BRAC round to further reduce costs and transform the American military from a Cold War fighting force into a force designed to address modern threats. This article reviews the ongoing 2005 BRAC process.

Transformation

Secretary of Defense Donald Rumsfeld announced his desire to transform America's military soon after taking office in 2001. To Rumsfeld and his supporters, transformation of the military entails changing a Cold War fighting force into a force comprised of lighter, more mobile, and more lethal combat units. DoD describes transformation as:

> [a] process that shapes the changing nature of military competition and cooperation through new combinations of concepts, capabilities, people and organizations that exploit our nation's advantages and protect against our asymmetric vulnerabilities to sustain our strategic position, which helps underpin peace and stability in the world. . . . U.S. defense strategy requires agile, network-centric forces capable of taking action from a forward position, rapidly reinforced from other areas, and defeating adversaries swiftly and decisively while conducting an active defense of U.S. territory.

Military Transformation: A Strategic Approach 2 (Fall 2003), available at www.oft.osd.mil/library/library_files/document_297_MT_StrategyDoc1.pdf.

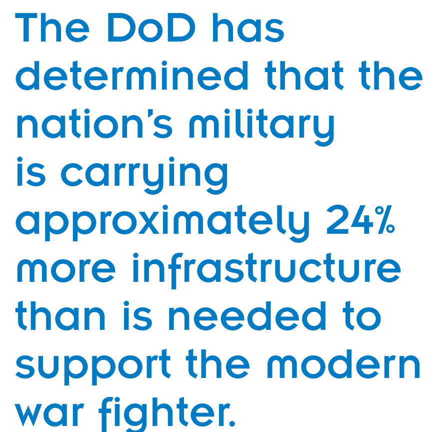
Meeting these objectives requires the transformation of the infrastructure that will support this new force. Another round of base closures is, therefore, viewed as a critical component of the transformation of America's military. As Secretary Rumsfeld stated in 2002, "BRAC 2005 should be the means by which we reconfigure our current infrastructure into one in which operational capacity maximizes both warfighting capability and efficiency." Memorandum from the Secretary of Defense to the Secretaries of the Military Departments (Nov. 15, 2002), available at www.defenselink.mil/brac/index.html.

The "Mother of All BRACs"

Before the publication of the Secretary's closure and realignment recommendations on May 13, 2005, the DoD determined that the nation's military was carrying approximately 24% more infrastructure than is needed to support the modern war fighter. *Report Required by Section 2912 of the Defense Base Closure and Realignment Act of 1990, as amended through the National Defense Authorization Act for Fiscal Year 2003* (Mar. 2004), available at www.defenselink.mil/brac/docs/04_0_body032403.pdf. This perceived excess infrastructure is the target of BRAC 2005. On May 13, 2005, the Secretary published his recommendations, including the closure of 33 major installations. This number of closures makes BRAC 2005 the largest base closure round to date. The last four base closure rounds combined resulted in the closure of 97 major installations. For this reason, BRAC 2005 is being referred to as the "mother of all BRACs." Leigh Dethman, *Bush's Budget May Mean Hill Is Safe for Now*, Deseret Morning News, Feb. 25, 2005, available at http://deseretnews.com/dn/view/0,1249,600114624,00.html.

Legislation

In December 2001, Congress enacted the National Defense Authorization Act of Fiscal Year 2002, which contained the legislative enabling provisions for a new round of base closures. National Defense Authorization Act for Fiscal Year 2002, Pub. L. No. 107–107, 115 Stat. 1012 (2001), 10 U.S.C. § 2687 note. Technically, the BRAC 2005 legislation consists of amendments to the Defense Base Closure and Realignment Act of 1990. Defense Base Closure and Realignment Act of 1990, Pub. L. No. 101–510, § 2901, 104 Stat. 1485 (1990). These amendments use the framework established by the previous legislation to enable a new closure round in 2005.



The DoD has determined that the nation's military is carrying approximately 24% more infrastructure than is needed to support the modern war fighter.

Although in large part the 2005 round of base closures will closely follow the process established in previous rounds, the BRAC 2005 enabling legislation does allow for important differences in its implementation. Perhaps the most notable difference between the BRAC 2005 legislation and that of previous rounds will prove to be the elimination of the No-Cost Economic Development Conveyance. The Economic Development Conveyance (EDC) is a property disposal authority for BRAC property dating back to 1993 when Senator David Pryor (D–Ark.) proposed an amendment to the 1990 BRAC Act that allowed for the conveyance of real and personal

---

Randall S. Beach is an associate with Whiteman Osterman & Hanna in Albany, New York.

AP Photo/Ric Francis

property to local reuse authorities (LRAs) to be used for economic development and job generation purposes. National Defense Authorization Act of 1994, Pub. L. No. 103–160, § 2903, 107 Stat. 1547 (1993). Specifically, the Pryor Amendment, as it became known, allowed the Secretary to "transfer real property and personal property located at a military installation to be closed . . . to the redevelopment authority . . . for consideration at or below the estimated fair market value of the property transferred or without consideration." Id. § 2903(a).

The advent of the EDC was a reaction to closure communities' frustration with the then-available property disposal methods. The most well-known disposal methods at that time were the Public Benefit Conveyance (PBC) and public sale. The PBC could be used to transfer property at no cost, but only for limited purposes such as education, airports, prisons, historical monuments, and parks and recreation. Federal Property and Administrative Services Act of 1949, as amended, 40 U.S.C. § 541 et seq., § 550, § 553, § 554. Public sale entailed the transfer of the property via either a negotiated sale or public auction process. Id. § 545. Neither the PBC nor the public sale method of property disposal allowed the LRA to gain property with sufficient flexibility to allow it to successfully reuse the property for economic development purposes. In contrast, the EDC allowed the military departments to convey former base property to the LRA for fair market value consideration and with fewer restrictions.

As originally configured, the EDC proved a useful tool in theory, but it presented practical difficulties for communities struggling to revitalize their economies. Communities that had just had their economic life blood stripped away by BRAC found the appraisal process that came hand-in-hand with the EDC drawn out and frustratingly closed to local access and input. Further, at the end of the process, these communities faced paying the military departments millions of dollars to regain property the communities had, in many cases, given to the DoD for installation use. That, coupled with the increasingly common, and often accurate, belief on the part of LRAs that they did not have a true understanding of the condition of the base properties, or of what it would take to make such property conducive to modern development, meant that successful EDC conveyances were few and far between and much BRAC property remained static.

The failure of the EDC tool to move property off the federal books resulted in another amendment to the BRAC Act in 1999. National Defense Authorization Act for Fiscal Year 2000, Pub. L. No. 106–65, § 2821, 113 Stat. 512 (1999). This time, members of Congress heard what closure communities had been trying to tell

them all along: the property had to be delivered in a manner that allowed the LRA the most flexibility in reuse (EDC-like), but it had to be conveyed at no cost to the LRA (PBC-like). Thus, the No-Cost EDC was born. The No-Cost EDC allowed for the conveyance of property for economic development and job generation at no cost to the LRA. The communities' cries for help were answered and BRAC property began, finally, to be successfully conveyed and redeveloped.

The BRAC 2005 legislation has now turned back the clock on the EDC. The EDC conveyance mechanism remains, but only in its pre-1999 configuration. The EDC provisions within the latest base closure act now provide that "the Secretary shall seek to obtain consideration in connection with any transfer . . . of property located at the installation in an amount equal to the fair market value of the property as determined by the Secretary." Pub. L. No. 107–107, § 3006, 115 Stat. 1012, 1350 (2001) (amending Pub. L. No. 101–510, § 2905(b)(4)(B)). The Secretary has the discretion, but is not obligated, to transfer property for less than fair market value or no consideration. Id.

One member of Congress has already attempted to restore the No-Cost EDC. In 2003, Rep. Sam Farr (D–Cal.) introduced a bill that would have made the No-Cost EDC mandatory for bases closed under BRAC 2005 and would have expanded the scope of the No-Cost EDC to include housing initiatives. H.R. 1903, 108th Cong. (2003). That bill was referred to the House Armed Services Committee and has not since emerged. At least for now, the No-Cost EDC will not be available to BRAC 2005 closure communities.

The Commission

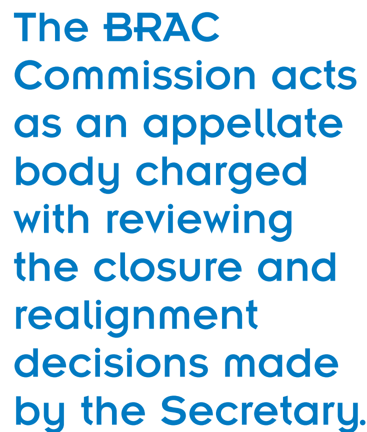
The 2005 BRAC Commission will consist of nine members nominated by the President of the United States and confirmed by the Senate. Pub. L. No. 107–107, § 3001, 115 Stat. 1012, 1342 (2001) (adding a new Section 2912 to Pub. L. No. 101–510). The legislation requires the President to nominate the full Commission no later than March 15, 2005. Id. § 2912(d)(1). The BRAC legislation allows the Speaker of the House and the Senate majority leader to each suggest two members for the President's consideration. Pub. L. No. 101–510, § 2902(c)(2). In the spirit of bi-partisanship, the legislation also allows the minority leaders of the Senate and House to suggest one member each to the President. Id. The remaining three members of the Commission are chosen by the

President in his discretion. The President also selects the Commission's chair from among the nominated members and the chair hires the Commission staff members. Id. § 2902(c)(3).

Essentially, the BRAC Commission acts as an appellate body charged with reviewing the closure and realignment decisions made by the Secretary. The Commission received the Secretary's recommendations on May 13, 2005, and will spend the next four months reviewing the DoD's closure decisions and the data supporting those decisions. Pub. L. No. 107–107, § 3003 (adding a new Section 2914 to Pub. L. No. 101–510). The Commission will first hold public hearings in Washington, D.C., receiving testimony from DoD officials, and then hold regional hearings across the country. Id.; Pub. L. No. 101–510, § 2903(d). These regional hearings are designed to allow each community with an installation selected by the Secretary for closure or realignment to appear before the Commission to present its case against base closure.

Unlike the President and Congress, the Commission is empowered to make changes to the list proffered by the Secretary. Pub. L. No. 101–510, § 2903(d)(2)(B). The BRAC 2005 legislation has, however, made the exercise of that power by the Commission more difficult. Under amendments included in the Defense Authorization Act for Fiscal Year 2005, adding an installation to the Secretary's list requires an affirmative vote of seven of the nine Commission members. Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005, Pub. L. No. 108–375, § 2834, 118 Stat. 1811 (2004). In addition, two members must visit the installation proposed to be added. Id. These requirements will likely make it difficult for the Commission to add bases to the Secretary's list.

Although its legislative authority expires on April 15, 2006, the BRAC Commission's role will essentially end on or before September 8, 2005, when the Commission must submit its final closure and realignment recommendations to the President. If the President accepts the list in its entirety, he must transmit the list to Congress no later than November 7, 2005. Pub. L. No. 107–107, § 3003 (adding a new Section 2914 to Pub. L. No. 101-510). On receipt of the list from the President, Congress has 45 days to reject the list en masse. Pub. L. No. 101–510, § 2903(e). If Congress does not act to reject the closure and



realignment list, the list is deemed accepted and final. Pub. L. No. 107–107, § 3003. The requirement that the President and Congress accept or reject the closure list en masse is an attempt by the drafters of the BRAC legislation to remove politics from the BRAC process.

Going . . . Going . . . Gone?

Although, as discussed above, the military departments have many different mechanisms under which they may dispose of BRAC real and personal property, DoD and the individual military departments have seemingly rediscovered one of the older property transfer mechanisms on the books, the public auction. The Navy has had two successful experiences with using public auctions to dispose of former installation property, and these successes are prompting the other military departments to reexamine the way that they dispose of BRAC property.

First, the Navy auctioned 240 acres of land at the former Tustin Marine Corps Air Station near the cities of Tustin, Irvine, and Santa Ana, California. The winning bidder for that property paid the Navy $208 million. George Stewart, *Helicopter Base Auction Nets $208 Million*, Irvine World News, Oct. 3, 2002. More recently, Lennar Corp., the nation's third largest home builder, was the winning bidder for approximately 3,700 acres of the former El Toro Marine Corps Air Station in Orange County, California. Jean O. Pasco, *One Bidder Wins It All at El Toro*, L.A. Times, Feb. 17, 2005, at B1. Lennar will reportedly pay the Navy $649.5 million in exchange for that property. Many at the DoD and among individual military departments view these auctions as model disposal initiatives.

Although few base properties in the United States have the unquestionable value that 3,700 acres in Orange County, California, do, disposal by public auction will be sought by the military departments at many, if not all, of the BRAC 2005 closure sites. The days of acquiring an entire base by a PBC or EDC transfer are most probably gone. More likely, the military department involved will seek to employ many disposal methods, including public auction, at a single site.

Closure communities should be wary of the public auction. In communities such as Orange County, the public auction combined with diligent local planning initiatives may indeed be successful. Most bases, though, are not located in places such as Orange County. For bases located in areas where property values are more typical, the public auction may be less feasible and much less desirable. Those LRAs that have spent the last decade or so attempting to redevelop former base property in rural areas, for example, will be the first ones to profess that, in those areas in which there is not an immediate market, LRAs must create the market.

Further, an attempt to submit even a portion of former base property to public auction may be equally disastrous. It should be understood that the military departments will be charged with disposing of the BRAC property as quickly as possible and for as much consideration as possible. It follows, therefore, that the military departments will likely seek to dispose of the property and recover their costs, or any portion thereof, via public auctions. It is logical that the military departments will seek to auction off the most valuable (which is to say, readily developable) portion of the base. LRAs charged with redeveloping base property and revitalizing the surrounding community's economy may find they need the income from that readily developable portion of the base to support the development of the remaining, less desirable, property. If the military department has auctioned the most valuable portion off to the highest bidder, the LRA will have lost a valuable tool in its efforts to redevelop the remaining property.

If the military department has auctioned the most valuable portion off to the highest bidder, the LRA will have lost a valuable tool in its efforts to redevelop the remaining property.

Conclusion

For those veterans of the base closure efforts of the last 20 years, this year's BRAC round will be familiar territory. For BRAC neophytes, the ensuing 12 months will be stressful and frustratingly confusing. Unfortunately, feelings of frustration and confusion are unlikely to be abated anytime soon for those communities that find their local bases on the final closure list transmitted to Congress by the President this fall. Although that act will represent the culmination of the BRAC closure determination, it marks the mere beginning of the often long and trying base redevelopment process that most closure communities will find consumes their economic and political resources for the foreseeable future and beyond.

In January of this year, the Government Accountability Office released a report updating the status of prior base closure rounds. *Military Base Closures: Updated Status of Prior Base Realignments and Closures*, GAO-05–138 (Jan. 2005), available at http://www.gao.gov/new.items/d05138.pdf. This report found that, as of September 30, 2004, the DoD had transferred about 72% of 504,000 acres that were subject to the 1988, 1991, 1993, and 1994 BRAC rounds. Id. at 10. The report cited environmental remediation as the reason why the remaining 28% of the unneeded property had not been transferred. Id. Although the DoD had reported estimated savings of $28.9 billion through fiscal year 2003, it had incurred an estimated $8.3 billion for environmental cleanup costs and, together with other federal agencies, an estimated $1.9 billion for redevelopment assistance for closure communities. Id. at 21, 24. Offering hope for the next closure communities, the GAO report also found that, of the 62 communities studied, 69% had unemployment rates equal to or lower than the national average and 48% had income growth rates higher than the national average. Id. at 28–29 nn.30–31. Despite this hope, the fact that 10 years have passed since the last BRAC round and a substantial portion of BRAC property from the 1988 closure round forward has not yet been disposed of is indication that the BRAC process is a long and difficult journey for all involved parties.

Fortunately, the new group of base closure communities will not be alone. They can draw on the collective experience of the communities that have lost their treasured military installations during the previous four BRAC rounds. The new closure communities also will have the resources offered by an entire base closure industry that has grown exponentially since the first BRAC round in 1988. Members of this niche industry include financial consulting firms, environmental consulting firms, planning firms, economic development consultants, private developers, and, of course, the legal profession. ■

The *Journal* is online!

Take a look today at the online *Journal*. You'll find it may help you in ways the printed *Journal* never could. Just point your browser to **www.abanet.org/rppt/journal.**

The Constitutionality of Decoupling

By Daniel B. Evans

The year 2004 marked the end of the federal estate tax credit for state death taxes, and the end of any state death tax in those states that have relied exclusively on a "pick-up tax" equal to the federal credit allowed. Seventeen states, however, are "decoupled" and will continue to impose a tax based on the state death tax credit as it existed under the Internal Revenue Code that was in force at the beginning of 2001, before Congress began the phase-out of the state death tax credit. But is it constitutional for a state to impose a tax based on the federal taxable estate if that taxable estate includes real property or tangible personal property located in other states?

Under Supreme Court decisions from 1925 and 1949, it is unconstitutional for a state to impose a succession tax on tangible property, whether real or personal, that is located in another state, and practitioners representing estates with tangible property in more than one state should challenge attempts by any state to impose a tax based on a value that includes tangible property in another state.

Decoupling

Under Code § 2011 as it existed before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107–16, 115 Stat. 38 (2001), estates were allowed a credit against the federal estate tax for death taxes paid to the state, but the credit was limited to an amount determined by applying a progressive schedule of rates against the federal taxable estate. EGTRRA reduced the credit by 25% for deaths in 2002, by 50% for deaths in 2003, and by 75% for deaths in 2004, then replaced the credit with a deduction for deaths in 2005 and later years.

Before EGTRRA, most states had state death taxes that were simply equal to the amount of the credit allowed against the federal estate tax. (Some states had separate inheritance, succession, or estate taxes, but even those states imposed a tax equal to the difference, if any, between the separate tax and the credit, so that every state imposed a death tax that was at least equal to the federal credit.) These "pick-up taxes" cost the residents of the state nothing because if the state did not impose the tax then the federal tax would be increased dollar-for-dollar and the same total amount of tax would be paid. The taxes were also easy to administer because the IRS would audit estate tax returns and check to see that the state death tax was actually paid, so all the states had to do was sit back and collect the money.

After EGTRRA, every state was faced with a choice: either change its death tax system or suffer a loss in tax revenues as the federal credit was phased out. In some states, the statutory definition of the state death tax was based on the Internal Revenue Code as of a date before EGTRRA, so in those states the pick-up tax would be calculated according to pre-EGTRRA law (and without any phase-out of the credit) until the state legislature amended the statutes to change the cross-reference to the Code. In those states, all the legislature needed to do was nothing.

In other states, the legislatures decided to roll back the clock and stop the phase-out, by changing the law to define the state death tax by reference to federal law as it existed before EGTRRA.

Regardless of how they got there, seventeen states are now "decoupled" and are claiming a state death tax based on a percentage of the federal "adjusted taxable estate" as defined in Code § 2011. But is that constitutional if the federal taxable estate includes tangible property located in another state?

State Taxes and the Constitution

Most lawyers and accountants know that there are geographical limits to what states can tax. So, for example, it has been held to be a violation of the Due Process Clause of the Fourteenth Amendment for states to impose taxes on the value of property outside of the state. Compare *Union Refrigerator Transit Co. v. Kentucky,* 199 U.S. 194 (1905). The same principle applies to the taxation of decedent's estates. (The same principle does not apply to income taxes, because a tax on the receipt of income is not the same as a tax on the property itself, and so a state may tax a resident on income received from property located outside of the state. *New York ex rel. Cohn v. Graves,* 300 U.S. 308 (1937).)

In *Frick v. Pennsylvania,* 268 U.S. 473 (1925), the Supreme Court ruled that Pennsylvania could not impose a tax on the value of tangible personal property that was located outside of Pennsylvania (in New York and Massachusetts), even though the property was owned by a decedent who was domiciled in Pennsylvania, because Pennsylvania had no power over property outside of the state. In *Treichler v. Wisconsin,* 338 U.S. 251 (1949), the court applied the same reasoning to hold that Wisconsin could not impose a tax on the estate of a decedent who was domiciled in Wisconsin when (1) the tax was a percentage of the federal estate tax

It is unconstitutional for a state to impose a succession tax on tangible property, whether real or personal, that is located in another state.

Andrew O. Alcala

Daniel B. Evans is in private practice in Philadelphia, Pennsylvania, and is the vice-chair of the Probate and Trust Division Economics and Technology of the Practice Committee. He is an associate probate and trust articles editor for *Probate & Property*.

payable and (2) the federal taxable estate included property located outside of Wisconsin. The tax was held to be invalid to the extent that it was measured by tangible property outside of Wisconsin.

These cases have never been overruled and were cited with approval as recently as 1982, when the Supreme Court stated that "[p]hysical presence also is required to justify a state succession tax on the transfer of real property occasioned by the death of the owner." *Cory v. White,* 457 U.S. 85, 98–99 (1982).

Effects of Decoupling

Before decoupling, pick-up taxes sometimes resulted in what amounted to a tax on property outside of the state, but it did not matter because it never cost any estate any money.

Before decoupling, every state had a pick-up tax and every state dealt with the problem of property in other states in one of three different ways. When a resident decedent had property in another state, the pick-up tax was either (1) reduced by the proportion of the federal taxable estate located outside of the domiciliary state, (2) reduced by any death tax imposed by the other state on the property located within that other state, or (3) reduced by the lesser of (1) or (2). Some of these formulations meant that a state might get more than its proportionate share of the federal credit, but only if the total of the state death taxes did not exceed the federal credit. (This would happen if, for example, there was property in another state, but that other state claimed a death tax that was less than a proportionate part of the federal credit. In that case, the domiciliary state would take the difference as part of its tax.)

States are now imposing a state death tax based on the federal taxable estate, even though there is no longer a federal credit for the tax, so there can be an additional cost to the estate and the estate has standing to complain.

As long as the total state death taxes did not exceed the federal credit, the estate would not be able to complain, even if the state claimed a credit attributable to property in another state. The estate would not be able to complain because the amount of the tax was a credit against the federal estate tax, and if the total amount of the state taxes did not exceed the federal credit, then the estate would have no standing to complain because there was no additional tax to pay and so no damage or loss to the estate. Any reduction in a pick-up tax would have increased the federal estate tax by the same amount, leaving the estate in the same position as before. In other words, "no harm—no foul." (The Pennsylvania Supreme Court relied on this rationale in rejecting a challenge to the Pennsylvania estate tax in *Knowles's Estate,* 145 A. 797 (Pa. 1929). The IRS, however, could still object to an unconstitutional state death tax. In Rev. Rul. 56–230, 1956–1 C.B. 660, the IRS announced that it would refuse to allow a credit for state death taxes claimed on property located outside of the taxing state.)

Decoupling has changed all that. Some states are now imposing a state death tax based on the federal taxable estate, even though there is no longer a federal credit for the tax, so there can be an additional cost to the estate and the estate has standing to complain. And there is reason to complain, because many states are no longer imposing any death tax and so states that have decoupled are now collecting taxes on property located in states that have not decoupled. For example, if a decedent who was a resident of New York or New Jersey (both of which have decoupled) also owned a condominium in Florida (which now imposes no death tax), the death tax imposed by New York or New Jersey will be as unconstitutional as the death tax imposed by Wisconsin in the *Treichler* case. The New York or New Jersey tax will be based on the value of the federal taxable estate, the federal taxable estate will include the value of property located out of state, and the tax on that property will be unconstitutional.

Of the seventeen jurisdictions that are decoupled, twelve will reduce the decoupled tax only by taxes actually paid to another state and will therefore be taxing property outside of the state when the other state imposes no death tax. Those twelve jurisdictions are the District of Columbia, Illinois, Kansas, Maine, Massachusetts, Nebraska, New Jersey, New York, North Carolina, Vermont, Virginia, and Washington. The five states that will reduce the decoupled tax in proportion to the value of property outside of the state (which is the constitutional formula) are Maryland, Minnesota, Oregon, Rhode Island, and Wisconsin.

Nondomiciliary States

A similar problem can arise with nondomiciliary states, but most nondomiciliary states calculate the decoupled tax in proportion to the value of the property located in the state compared to the value of the entire federal taxable estate, which is constitutional.

One state that initially tried to collect more than a proportion of the decoupled tax was New York, but the constitutional issue was recognized and the law has been amended to make the tax proportionate. For a discussion of the constitutional issue, see Mal L. Barasch & Kara B. Schissler, *The New York Non-Resident Estate Tax: A Tax That Can Be Less*

Than It Seems to Be, 36 NYSBA Trusts and Estates Law Section Newsl. No. 4 (Winter 2003).

Tax Rates

For both domiciliary states and nondomiciliary states, it could also be argued that there is a problem even if the decoupled tax is apportioned between the states, because the rate table in Code § 2011 is progressive and the use of the federal taxable estate as the tax base causes the property in any one state to be taxed at a higher rate than would be the case if the same rate table were applied only to the value of the property in that state. So, for example, if $2 million of a $8 million estate were located in a decoupled state, a proportionate tax would be $193,300—one-fourth of the $773,200 tax on $8 million—while the tax on a $2 million taxable estate would be only $99,600. It could be claimed that the increase in tax rates caused by the inclusion of property outside of the states is unconstitutional.

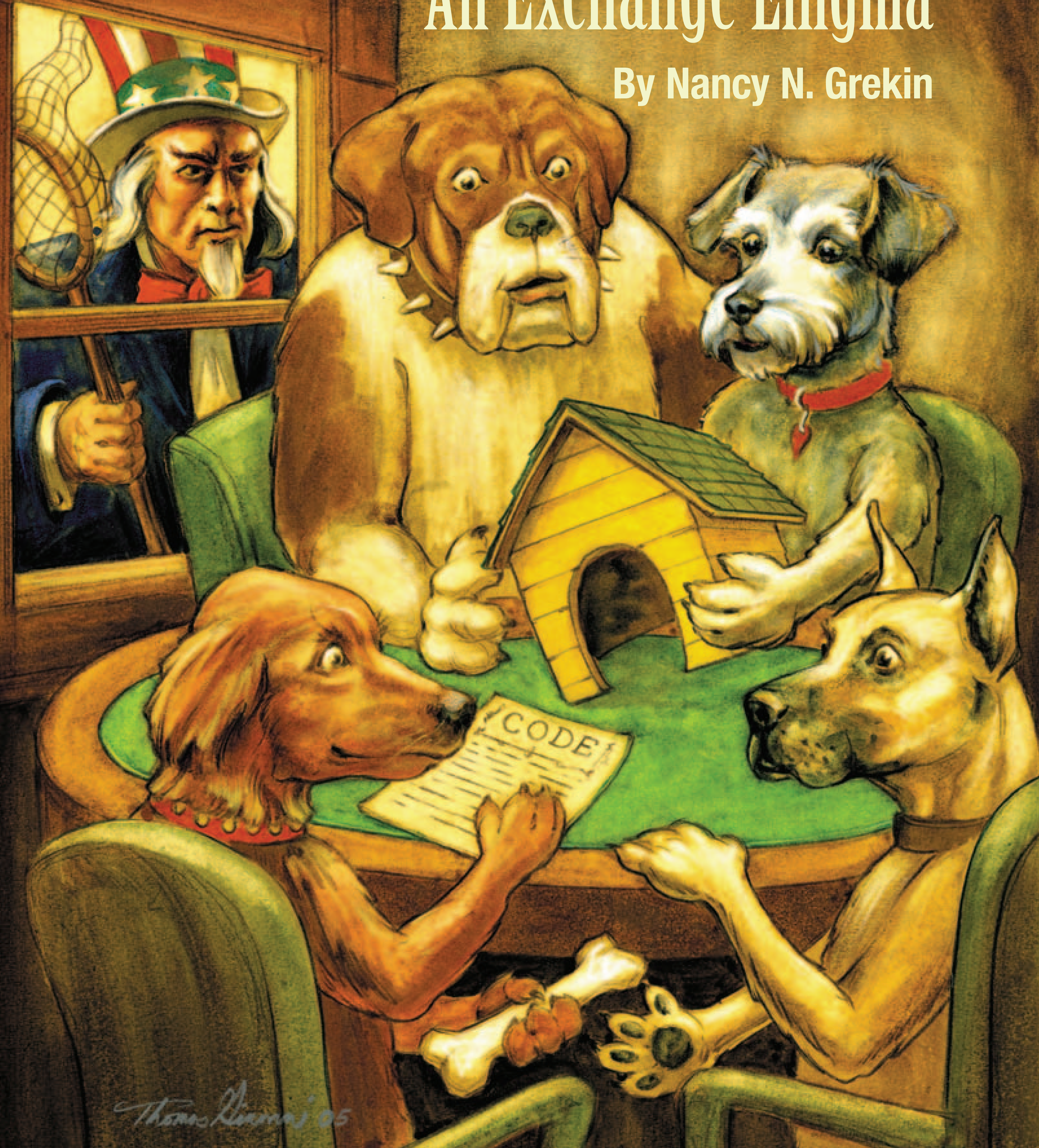
Unfortunately, the Supreme Court considered this argument in 1919 and rejected it. *Maxwell v. Bugbee,* 250 U.S. 525 (1919). The reason the Supreme Court rejected the argument was that the issue was not whether the state had the power to tax the property, but whether it was applying a proper rate of tax, and the constitutional standard is different. When applying the Equal Protection Clause to challenges to the rates of taxes imposed by states, courts have applied the "rational basis" test, which is a very minimal standard. Courts have therefore allowed different tax rates for different beneficiaries with different relationships to the decedent, as well as progressive tax rates for larger inheritances. See, e.g., *Magoun v. Illinois Trust and Savings Bank,* 170 U.S. 283 (1898). The imposition of a progressive tax rate based on property outside of the taxing jurisdiction is just as defensible. (Similar constitutional arguments have been made about the so-called "kiddie tax," which causes the unearned income of a minor child to be taxed at the marginal tax rates of the parent, and the constitutionality of that tax has been upheld by at least two federal district courts.)

Conclusion

Even simple laws often have consequences that are difficult to predict. Decoupling may have seemed like a simple solution to states facing a loss of revenue after Congress decided to phase out the state death tax credit, but it has raised some complex issues, including the constitutionality of a state attempting to tax the value of tangible property located in another state. Lawyers and accountants representing estates with property in more than one state should be mindful of the constitutional issue and should resist overreaching by the states that have decoupled. ■

Related Party Exchanges— An Exchange Enigma

By Nancy N. Grekin



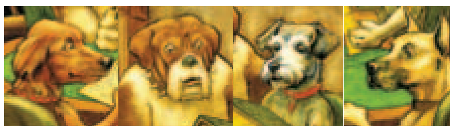
Code § 1031, deferral of recognition of gain on disposition of a qualifying asset that is replaced with like-kind property, has been a part of the tax code since the Revenue Acts of the 1920s. Before the decision of the Ninth Circuit in the *Starker* case, it appeared that a Code § 1031 exchange could be accomplished only by two taxpayers exchanging directly with each other. *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979). Taxpayers tried a variety of creative structures for accomplishing exchanges without a direct trade, and the IRS regularly challenged these structures both before and after *Starker,* arguing that the third party holding the funds or acquiring one of the properties in the exchange was the agent of the taxpayer and that the transaction should be collapsed as a step transaction.

In 1991, the IRS finally conceded the use of intermediaries by adopting the deferred exchange regulations. Treas. Reg. § 1.1031(k)–1. But before the regulations, the Tax Court and other federal courts deciding exchange cases were typically taxpayer-friendly, steadfastly resisting the IRS's attempts to recharacterize or collapse exchange transactions. As an example of this tendency to favor the taxpayer, the Tax Court expressed the view that the structure of an exchange should be respected in this way:

> The "exchange" requirement poses an analytical problem because it runs headlong into the familiar tax law maxim that the substance of a transaction controls over form. In a sense, the substance of a transaction in which the taxpayer sells property and immediately reinvests the proceeds in like-kind property is not much different from the substance of a transaction in which two parcels are exchanged without cash. Yet, if the exchange requirement is to have any significance at all, the perhaps formalistic difference between the two types of transactions must, at least on an occasion, engender different results.

Barker v. Commission, 74 T.C. 555, 561 (1980) (citations omitted).

Adopted in 1989, Code § 1031(f) is the most recent amendment to Code § 1031, imposing special restrictions on exchanges between related parties.



If related parties exchange directly, each must hold the property acquired from the other for two years to avoid having both exchanges disallowed.

Following this amendment, the Tax Court for the first time in the evolution of exchange cases collapsed and recharacterized an exchange transaction, disregarding the structure and disallowing the exchange. *Teruya Brothers, Ltd. v. Commissioner,* 124 T.C. No. 4 (Feb. 9, 2005).

This article analyzes the consequences of the Tax Court's decision in that case.

Code § 1031(f)

Code § 1031(f) includes four subsections that (1) establish a holding period for exchanges between related parties, (2) provide three limited exceptions to the holding period, (3) define who is a related party for purposes of the section, and (4) include an exception disallowing exchanges for related party exchanges structured to avoid Code § 1031(f).

Code § 1031(f)(1): The Two-Year Holding Period

Code § 1031(f)(1) provides that if a taxpayer transfers relinquished property to a related person, or acquires replacement property from a related person, the party acquiring the property received in the exchange must hold that property for two years or the exchange will be disallowed. If a taxpayer carries out a deferred four-party exchange, it appears that Code § 1031(f) applies only to the property transferred or acquired in the exchange. This means that if a taxpayer sells his or her relinquished property to a related party, the related party must hold it for two years for the taxpayer to comply with Code § 1031(f)(1). If the taxpayer acquires replacement property from a related party, the taxpayer must hold it for two years. If related parties exchange directly, each must hold the property acquired from the other for two years to avoid having both exchanges disallowed.

The legislative history of this section indicates that Congress was concerned with "basis shifting" between related parties, specifically that related parties could engage "in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale." H.R. Rep. No. 101–247, at 1340 (1989). The transaction about which Congress was concerned was one in which a taxpayer wanting to sell low-basis property might first exchange that property with a related party for high-basis property. The related party would carry over its high basis to the property that formerly had a low basis in the exchanging party's hands, and, if the related party then sold the relinquished property, he would recognize little gain.

Responding to these perceived abuses, Congress concluded that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." Id. The perceived abuse was limited in the Code by requiring a two-year holding period, a codification of the revenue agent's "old and cold" rule that transactions occurring within two years of each

---

Nancy N. Grekin is a partner in the Honolulu, Hawaii, office of McCorriston Miller Mukai MacKinnon LLP and vice-chair of the Real Property Division Economics, Technology and Practice Methods Committee.

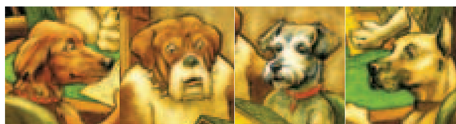
Thomas Gianni

other that result in tax avoidance to one of the parties can be collapsed or disregarded.

Code § 1031(f)(2): Exceptions to the Two-Year Holding Period

Recognizing that taxpayers might need to transfer property acquired in a related party exchange for reasons unrelated to tax-avoidance, Congress included three limited exceptions to the two-year holding period of Code § 1031(f)(1). Code § 1031(f)(2). These exceptions permit a disposition

1. after the earlier of the death of the taxpayer or the death of the related person,
2. in a compulsory or involuntary conversion (within the meaning of Code § 1033) if the exchange occurred before the threat or imminence of such conversion, or
3. for which it is established, to the satisfaction of the Secretary, that neither the exchange nor such disposition had as one of its principal purposes the avoidance of federal income tax.



Read together, Code § 1031(f)(1) and (f)(4) appear to establish a "right" way and a "wrong" way to carry out a related party exchange.

Code § 1031(f)(3): Definition of Related Parties

Code § 1031(f)(3) defines related parties to include "any person bearing a relationship to the taxpayer described in Code § 267(b) or § 707(b)(1)." Code § 267(b) defines the following as related parties:

- members of a family, including brothers and sisters (whether by the whole or half blood), spouses, ancestors, and lineal descendants;
- an individual and a corporation of which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for such individual;
- two corporations that are members of the same controlled group within the meaning given to the term by Code § 1563(a) (which defines controlled and related groups of corporations for purposes of other sections of the Code), except "more than 50%" is substituted for "at least 80%," and the determination is made without regard to Code §§ 1563(a)(4) and 1563(e)(3)(C);
- a grantor and a fiduciary of any trust;
- a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- a fiduciary of a trust and a beneficiary of such trust;
- a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- a fiduciary of a trust and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- a person and an organization to which Code § 501 (relating to certain educational and charitable organizations that are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
- a corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation, and more than 50% of the capital interest, or the profits interest, in the partnership;
- an S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation;
- an S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation; or
- except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

Code § 707(b) defines the following as related parties:

- a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or the profits interest, in such partnership, or
- two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests.

Code § 1031(f)(4): Transactions Structured to Avoid Code § 1031(f)

Congress recognized that related parties might attempt to circumvent Code § 1031(f)(1) to avoid the two-year holding period by using an unrelated third party to acquire the property in an exchange. Code § 1031(f)(4) was adopted to deal with this perceived abuse and it provides as follows: "[Code § 1031] shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of [Code § 1031(f)]."

The legislative history of this section included an example of the structure of a transaction that would cause an exchange to be disallowed under Code § 1031(f)(4):

> [I]f a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031.

H.R. Rep. No. 101–247, at 1341. The facts contemplated by the example

assume that a taxpayer wanting to acquire a replacement property from a related party might first arrange to have the related party sell the property to the buyer of the relinquished property so that the taxpayer could trade with the unrelated third party and avoid Code § 1031(f)(1). This transaction is clearly designed to avoid Code § 1031(f)(1) and is perhaps the only structure that would result in the exchanging party's not having transacted directly with the related party while acquiring the related party's property or disposing of property to a related party.

Read together, Code § 1031(f)(1) and (f)(4) appear to establish a "right" way and a "wrong" way to carry out a related party exchange. A taxpayer who transacts directly with a related party is subject to the two-year holding period. By contrast, a taxpayer who does not transact directly with the related party but nonetheless acquires the related party's property or disposes of the relinquished property in such a way as to result in the related party's acquiring it would not be subject to Code § 1031(f)(1) and the exchange would be disallowed under Code § 1031(f)(4) as one structured to avoid it because the taxpayer interposed an unrelated third party and avoided dealing directly with the related party.

Interestingly, whether a taxpayer structures an exchange in which replacement property is acquired from a related party the "right" way or the "wrong" way, precisely the same result occurs: the taxpayer owns the related party's property and the related party is paid the cash resulting from the sale. This odd result appears to be the focus of the rulings disallowing related party exchanges under Code § 1031(f)(4).

The Negative Rulings

In a series of rulings culminating in a recent Tax Court case, the IRS and now the Tax Court have disallowed related party exchanges in which the taxpayer acquired replacement property from a related party. In none of the rulings did the taxpayer dispose of the property within the two-year holding period, and in the Tax Court case the court explicitly so noted. Rather, the exchanges were disallowed because the taxpayer used an intermediary to "acquire" the replacement property and it was ruled by the IRS and held by the Tax Court that this constituted a structure designed to avoid Code § 1031(f), and the exchanges were therefore disallowed under Code § 1031(f)(4).

Interestingly, before the *Teruya Brothers* case was decided, the IRS allowed related party exchanges in two cases in which an accommodator was used. The first of these rulings, PLR 200251008, involved a related party reverse build-to-suit exchange. The subject of the ruling was the adequacy of a leasehold interest in the replacement property as qualified indicia of ownership under Rev. Proc. 2000–37, the reverse exchange revenue procedure; no ruling on the related party transaction was requested. Nonetheless, the IRS noted that it was a related party transaction, but it ruled that so long as the taxpayer acquiring the property held it for two years, the transaction would be in compliance with Code § 1031(f). The fact that an accommodator acquired, held, and improved the property in the exchange apparently had no bearing.

The second ruling, PLR 200440002, involved a related party exchange in which the related party seller also exchanged, and an accommodator was used. In this ruling the IRS held that, because the related party had not "cashed out," the use of an accommodator would not cause the exchange to be disallowed under Code § 1031(f)(4), noting that this was a limited exception to its prior rulings.

Teruya Brothers, Ltd. v. Commissioner

Uncertainty about the effect of these rulings has now been settled by the Tax Court. *Teruya Brothers Ltd. v. Commissioner,* 124 T.C. No. 4 (Feb. 9, 2005). The taxpayer in this case sold the leased fee under two condominiums in two separate exchanges. In both cases the taxpayer acquired replacement property from a related entity using a qualified intermediary. The parties stipulated that the exchanges met the requirements of the regulations and the court noted that the taxpayer continued to hold the replacement properties after expiration of the two-year holding period of Code § 1031(f)(1). But the court upheld the disallowance of the exchange because "the qualified intermediary was interposed in an attempt to circumvent the section 1031(f)(1) limitations that would have applied to exchanges directly between related persons." Id. at 19.

In its discussion and reasoning, the court first described the legislative history of Code § 1031(f)(1) and observed that the IRS in this case equated "a qualified intermediary with the 'unrelated party' referred to [in the legislative history of Code § 1031(f)(4)]" and that the IRS argued that such an exchange should be "recast as a direct exchange between the related parties." It noted the IRS's argument that if Code § 1031(f)(1) would "preclude nonrecognition treatment for the recast transaction . . . then the deferred exchange should be deemed to have been structured to avoid the purposes of section 1031(f)," but rejected this as a theory of why the exchange should be disallowed. The court did, however, disallow the exchange based on the use of the intermediary.

The court noted that the IRS failed to analyze whether the transaction was within the non-tax-avoidance exception of Code § 1031(f)(2). Discussion of the non-tax-avoidance exception appears on the face of the Code to be misplaced because the non-tax-avoidance section provides that "for purposes

of paragraph (1)(C)," non-tax-avoidance may provide an exception. But paragraph 1(C) is the two-year holding period of Code § 1031(f)(1), so the exception does not appear to apply at all to Code § 1031(f)(4) and should therefore not have any bearing on whether the exchange should be allowed or disallowed if Code § 1031(f)(4) were breached. Rather, Code § 1031(f)(4) appears to be a per se rule that applies regardless of the taxpayer's intent.

The Tax Court noted that even if *Teruya* did not intend to make a direct sale of the property, "this does not mean . . . that the deferred sale was not structured so as to avoid Federal income taxes. The economic substance of the transactions remains that the investments in [the relinquished properties] were cashed out immediately and [the related party seller] ended up with the cash proceeds." This statement may demonstrate that the court was recasting the related party transaction and treating it as if the related party had first sold the replacement property to the buyer who then exchanged with the taxpayer, the example in the legislative history of Code § 1031(f) that would cause an exchange to be disallowed.

In analyzing the tax consequences to the related party seller, the Tax Court noted that the seller recognized gain on one of the transactions, which was offset by a net operating loss, and did not recognize a loss on the other transaction under Code § 267(b). Thus, the Tax Court apparently took into consideration the cash and tax consequences to the related party seller in determining that the exchanging party taxpayer had violated Code § 1031(f)(4), and apparently attributed those consequences to the exchanging party taxpayer. This holding is perplexing because in a Code § 1031 exchange there is no requirement that the tax consequences to the seller of the replacement property be considered and the related party rules do not otherwise require this.

Finally, the Tax Court noted that the petitioner offered no explanation for its use of a qualified intermediary and therefore "inferred" that the use of the intermediary was an attempt to circumvent the Code § 1031(f)(1) limitations that would have applied to "exchanges directly between related persons." This is the most puzzling of the Tax Court's holdings because a taxpayer has little choice but to use an intermediary to handle funds between transactions to qualify under the safe harbor of the regulations, and, for the intermediary to be qualified, the taxpayer must "interpose" the intermediary in the transaction by having it acquire the properties in the exchange.

The regulations provide that the intermediary can "acquire" the properties in an exchange in one of three ways: the intermediary can (1) execute the contracts for sale or purchase but direct that the properties be directly conveyed to the buyer or taxpayer, (2) take legal title to the properties then reconvey them to the buyer or taxpayer, or (3) receive an assignment of the taxpayer's rights under the contracts. Treas. Reg. § 1.1031(k)–1(g)(4)(iii)(b). The third method is the one most commonly used, and was the method used by the taxpayers in each of the negative rulings. Interestingly, the safe harbors of the regulations do permit use of escrow and trust arrangements to handle exchange funds, and this safe harbor does not require that the escrow or trust acquire the properties in the exchange. The taxpayer in the *Teruya Brothers* case did not structure the exchange in this manner, so the Tax Court did not address whether it would be allowed.

Musings on the Rulings

Treating a related party exchange in which a qualified intermediary is used as one structured to avoid Code § 1031(f) effectively writes Code § 1031(f)(1) out of the Code for taxpayers who wish to acquire replacement property from a related party in a deferred four-party exchange, if the exchange must be structured using a qualified intermediary. This result conflicts with the apparent view of the Tax Court before this case that the structure of an exchange should be respected.

Should the use of an intermediary qualified under the deferred exchange regulations be treated as an attempt to avoid the applicability of Code § 1031(f)? A taxpayer carrying out a deferred exchange has no choice but to use an intermediary to hold the exchange funds and to qualify the intermediary under the regulations. The acquisition by the intermediary, however, serves no purpose but to qualify the intermediary and the intermediary's role is therefore transparent. Typically, the intermediary does not acquire legal title to the properties in the exchange; rather, the acquisition requirement is met with an assignment of the taxpayer's contract rights to the intermediary. The use of an accommodator should not be treated as having insulated the taxpayer from Code § 1031(f)(1) and therefore cannot be held to have resulted in a transaction that is tainted under Code § 1031(f)(4). A related party exchange in which an intermediary is deemed to have "acquired" the property in the exchange should be treated as a related party exchange in which the taxpayer is subject to the two-year holding period of Code § 1031(f)(1). The fact that the taxpayer ends up with the related party's property and the related party ends up with the cash paid for the property should not result in collapsing the transactions because the result is expected in an exchange and occurs whether or not the taxpayer exchanges with a related party. No tax avoidance occurs that would not occur in an exchange with an unrelated third party; the related party seller recognizes gain or does not recognize loss, and the taxpayer carries over his or her basis to the replacement property.

Conclusion

A client wishing to acquire replacement property in a deferred four-party exchange in which a qualified intermediary is used should be advised that under the Tax Court ruling the exchange would be disallowed. It remains to be seen whether an escrow or trust arrangement in which an intermediary need not "acquire" the properties in the exchange might be allowed. ■

State Income Taxation of Trusts

By Bradley E.S. Fogel

State taxes are easily overlooked in estate planning. Most states have been "soak-up" (or "pick-up") states imposing a tax equal to the federal estate tax credit for state death taxes (which was phased out as of January 1, 2005), so that minimizing federal estate tax also minimizes the state estate tax. Similarly, transactions that reduce the federal taxable income of a trust frequently minimize the state tax burden. If the attorney is not careful, however, a trust may be taxed on all of its income by many states. In contrast, if the attorney aligns the trust carefully, it is sometimes possible to avoid state income taxation completely. With state income tax rates that range up to 12%, this is not an issue that should be overlooked. State income taxation can be especially important in the many states that do not provide reduced rates for capital gains because even a trust that distributes all income currently may be taxed on its capital gain.

Many states tax the income of trusts in a manner similar to state taxation of individuals. Towards that end, trusts are frequently divided into two classes—resident trusts and nonresident trusts. Generally, resident trusts, like resident individuals, are taxed on all income from whatever source derived. In contrast, nonresident trusts are taxed only on income derived from sources within the taxing state. See, e.g., Cal. Rev. & Tax. Code § 17301.3.

States have various rules for determining which trusts are resident trusts. For example, in Arizona a trust is a resident trust if at least one trustee is a resident of Arizona. Ariz.

Bradley E.S. Fogel is an associate professor of law at Saint Louis University School of Law in St. Louis, Missouri.

Andrew O. Alcala

Rev. Stat. § 43–1301(5). (If the Arizona trustee is a corporate trustee, the trust will be an Arizona resident only if the trust is also administered in Arizona.) A trust that is administered in Colorado is a Colorado resident trust. Colo. Rev. Stat. Ann. § 39–22–103(6); see also Kan. Stat. Ann. § 79–32,109(d); S.C. Code Ann. § 12–6-30. A trust will be a Hawaii resident trust if at least one trustee is a Hawaii resident *or* the trust is administered in Hawaii. Haw. Rev. Stat. § 235–1; see also Or. Rev. Stat. § 316.282(1)(d). The various states that determine trust residency based on where the trust is administered introduce the question of exactly how to determine the place of administration for purposes of the state income tax. In some states, a trust is deemed administered where the majority of fiduciary decisions are made. Or. Rev. Stat. § 316.282(1)(d).

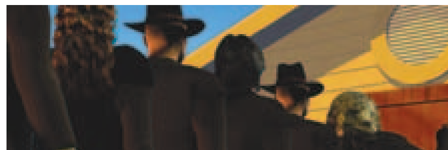
What seems to be the most common method used to determine trust residency is particularly problematic. Specifically, many states (for example, New York, Pennsylvania, Minnesota, Michigan, Delaware, the District of Columbia, and others) determine trust residency at the moment the trust is created. So, for example, a testamentary trust will be a Connecticut resident trust if it was created under the will of an individual who died a resident of Connecticut. An irrevocable inter vivos trust is a Connecticut resident trust if it was created by a Connecticut resident individual or if the settlor was a Connecticut resident when the trust became irrevocable. Conn. Gen. Stat. § 12–701(4). This "residence by birth" method of determining trust residency is problematic in that it ignores the absence of current connections between the state and the trust. Thus, a trust that has no current connection to Connecticut may be taxed by Connecticut solely because it was created by a Connecticut resident. This would be true even if the trust was created decades ago.

Constitutional Limitations on the Residence by Birth Method

States' taxation of trusts that have no current connection to the taxing state has raised constitutional challenges. More often than not, the taxpayer has been successful in these challenges. Relatively recent U.S. Supreme Court precedent, however, makes taxpayers' continued success in this area less likely.

The facts of the several constitutional challenges to the residence by birth taxation system are quite similar. In these cases, the taxpayer is a trust created by a resident of the taxing state. The trust has no ongoing connection to the state. Because the taxing state uses the residence by birth method of determining trust residency, however, the trust is deemed a resident trust and is taxed on all of its income.

BECAUSE OF THE LACK OF A CURRENT CONNECTION BETWEEN THE TRUST AND THE STATE, THE TAXPAYER ARGUES THAT THE STATE'S TAXATION OF THE TRUST VIOLATES THE DUE PROCESS AND COMMERCE CLAUSES OF THE U.S. CONSTITUTION.



Because of the lack of a current connection between the trust and the state, the taxpayer argues that the state's taxation of the trust violates the Due Process and Commerce Clauses of the U.S. Constitution.

This issue has been addressed by several different state courts. The courts that decided this issue before the U.S. Supreme Court's 1992 decision—*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)—held that state taxation of a trust with no *current* connection to the state was unconstitutional. Thus, a trust created by a Michigan resident, and thus deemed a Michigan resident trust under Michigan law, cannot constitutionally be taxed by Michigan unless there is a *current* connection between Michigan and the trust. *Blue v. Department of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990).

Generally, these pre-*Quill* state courts did not clearly delineate whether their analyses were based on the Due Process Clause or the Commerce Clause. Conflation of the Due Process and Commerce Clause claims may have been appropriate under pre-*Quill* U.S. Supreme Court precedent. *Quill*, 504 U.S. at 305. But it is untenable post-*Quill.*

In *Quill*, the Supreme Court addressed North Dakota's attempt to force Quill Corporation to collect North Dakota use tax for sales Quill made, via mail-order, to North Dakota residents. Quill Corporation had no office, employees, or property in North Dakota. 504 U.S. at 301. The *Quill* Court held that the Due Process Clause required only the sort of "minimum contacts" that would justify jurisdiction over the taxpayer. The Court held that the low due process standard was met. 504 U.S. at 308.

Turning to Quill's Commerce Clause claim, the Court employed a four-part test to consider the burden on interstate commerce. Based partially on the fear of suddenly subjecting the enormous mail order industry to use taxes in the various states, the Court held that North Dakota's attempt to collect its use tax from Quill was barred by the Commerce Clause. Id. at 316–18.

Although *Quill* involved an attempt to collect use taxes and the Court specifically limited its holding to that context, state courts addressing the constitutionality of state income taxation of resident trusts have relied heavily on *Quill.* After *Quill,* both Connecticut and the District of Columbia courts addressed the state's power to tax a trust with little connection to the state. *Chase Manhattan Bank v. Gavin,* 733 A.2d 782 (Conn. 1999); *District of Columbia v. Chase Manhattan Bank,* 689 A.2d 539 (D.C. 1997). Although the pre-*Quill* cases generally found taxation of such

trusts unconstitutional, the post-*Quill* cases held the tax constitutional. The post-*Quill* Connecticut case, *Gavin*, is illustrative of the unsettled nature of the law in this area.

In *Gavin,* the Connecticut Supreme Court addressed several trusts created by Connecticut residents. The court held that Connecticut's taxation of each trust was constitutional. The trust with the most attenuated connection to the state of Connecticut was a testamentary trust created in 1968 under the will of a Connecticut resident. Connecticut law provides for the residence by birth method of determining trust residency; thus, the trust was deemed a Connecticut resident trust

A MINOR, ONGOING LINK BETWEEN THE STATE AND THE TRUST MAY BE SUFFICIENT TO ALLOW THE STATE TO TAX ALL TRUST INCOME.

and Connecticut attempted to tax the trust's undistributed income. In rejecting the taxpayer's Due Process Clause argument, the court reasoned that the Connecticut probate court's continuing jurisdiction over the trust (to settle accounts, and so on) was a sufficient "minimum contact" between the state and the trust that would justify Connecticut's taxation of the trust under *Quill.*

In addressing the taxpayer's Commerce Clause claim, the *Gavin* court acknowledged the risk of multiple taxation. Double taxation is not, however, per se unconstitutional. *Gavin*, 733 A.2d at 805. The court reasoned that the potential for double taxation did not impose a burden on interstate commerce because it is unlikely that a Connecticut resident individual would discriminate against an out-of-state trustee just to minimize the risk of multiple taxation. Id. at 806. Thus, the court rejected the taxpayer's Commerce Clause claim.

The *Gavin* court also addressed one inter vivos trust. The court noted that state taxation of an inter vivos trust based solely on the settlor's residence when the trust was created (or became irrevocable) was a "closer case" than the analogous issue in the testamentary trust context. Presumably, this distinction is because of the lesser state court involvement in inter vivos trusts. Although the court held that Connecticut's taxation of the inter vivos trust was constitutional, the court relied on a *current* "critical link" between the trust at issue and Connecticut. Id. at 802. Specifically, the main beneficiary of the trust was a Connecticut resident. Thus, it is possible that an inter vivos trust created by a Connecticut resident could escape taxation by Connecticut if there was no current connection between Connecticut and the trust.

Although *Gavin* held that Connecticut may constitutionally tax any testamentary trust created under the will of a Connecticut resident and *might* be able to tax any inter vivos trust created by a Connecticut resident, most of the other cases that have addressed this issue reached contrary conclusions. Of course, these contrary decisions are all pre-*Quill.*

In response to the constitutional issues, some states have enacted statutes (or taxing authority regulations) that avoid the issue. See, e.g., R.I. Gen. Laws § 44–30–5(c); N.Y. Personal Income Tax Reg. § 105.23 (1997). For example, Missouri generally uses the residence by birth method of determining trust residency. But after a state court held that Missouri may not constitutionally tax a trust with no current connection to the state, the legislature revised the statute to provide that a trust will be a Missouri resident only if it is created by a Missouri resident and at least one income beneficiary is a Missouri resident. Mo. Rev. Stat. § 143.331. Thus, limitations on a state's taxation of resident trusts can be found in the statutes or regulations of the state as well as in case law. On the bright side, the states that have amended their laws to avoid the constitutional issues have avoided some of the uncertainty inherent in those issues.

Even in states that bar taxation of resident trusts without a current connection to the state, a minor, ongoing link between the state and the trust may be sufficient to allow the state to tax all trust income. For example, a Missouri court used a small parcel of Missouri real property owned by a trust as a hook to justify Missouri's taxation of all undistributed trust income. *Westfall v. Director of Revenue*, 812 S.W.2d 513 (Mo. 1991) (*Westfall* was decided before the change to the Missouri statutes discussed above). Thus, a small incidental connection between the trust and the state can have significant tax consequences.

Credits

It is a common misconception that because most states allow residents to take a credit for taxes paid to other states, there is little risk of multiple taxation. Although the credits ameliorate the risk of multiple taxation in some instances, the risk of multiple taxation remains significant and potentially costly.

In many states, the credit is limited to tax paid to another state on income derived from that state. See, e.g., Mo. Rev. Stat. § 143.081(1); Conn. Gen. Stat. § 12–704(a). Thus, for example, the credit would be available to offset income tax paid by a resident to another state based on income derived from real property located in that other state. The credit would not be available, however, to offset state tax imposed on income from intangibles, such as stocks.

In addition, in some states the credit is available only if the other state's tax is imposed "irrespective of the residence or domicile" of the tax-

payer. Haw. Rev. Stat. § 235–55(a); see also, e.g., Mont. Code Ann. § 15–30–124(c)(2). This limitation would prevent a trust deemed a resident of more than one state from using the credit because the tax is imposed based on the trust's residence in both states.

In essence, the problem with the credits is that they are intended for the situation in which a single state taxes the taxpayer as a resident, but the taxpayer pays tax as a nonresident to a different state only on its source income. In such a case, the state of residence would typically give the taxpayer a credit for the tax paid to the other state. In that kind of case, the credit greatly alleviates double taxation. For a trust that is deemed a resident of more than one state, however, the credits may not apply, and the problem of double taxation will continue without relief.

Multiple Taxation and Nontaxation

As discussed above, states determine residency of trusts in a variety of different ways. Although the Constitution limits some of the most expansive attempts to tax trusts, these limitations apply only to the most extreme cases. Further, the constitutional limits are not recognized in some states. The varied rules combined with only slight constitutional limitations make the risk of multiple taxation quite significant.

Suppose, for example, that a trust is created by a Connecticut resident. Suppose further that the trust is administered in Colorado and has two individual trustees—one a resident of Hawaii and the other a resident of Arizona. In that case, the trust would be deemed a resident by Connecticut, Colorado, Hawaii, and Arizona, and each of those four states would tax undistributed trust income. When a trust is subject to multiple taxation, it is possible that some of the states will give the trust a credit for tax paid to other states; however, as mentioned, such credits do a poor job of alleviating multiple taxation.

Because some states tax a trust as a resident trust if at least one trustee is a resident of that state, the number of states that could deem a given trust a resident is limited only by one's creativity in creating a "perfect storm" of state taxation. For example, it is possible that a trust created in one state, administered in another, with three trustees each of whom resides in a different state from the others, could find itself taxed on all of its income by five different states. In addition, of course, other states will treat the trust as a nonresident and tax it on all income from sources within those other states.

The flip side of the multiple taxation coin is the brass ring of the state income taxation of trusts. Specifically, if a trust is arranged properly, it is sometimes possible that a trust with connections to a variety of states that impose an income tax may still completely avoid state income taxation. For example, posit a trust created by a resident of Colorado. Suppose the trustees are residents of Missouri and New York and the trust is administered in Arizona. Even though Colorado, Missouri, New York, and Arizona all impose an income tax on trusts, the trust posited would not be deemed a resident in any of those states. Thus, unless the trust has income from sources within a state that imposes an income tax, this trust completely escapes state income taxation. The trust falls through the cracks of state income taxation because of the different ways that states determine trust residency.

Planning for State Income Taxation of Trusts

In the planning stage, when considering state income taxation of trusts, the first step is to determine the significance of the issue to a particular trust. Most states follow the federal model for determining the taxable income of a resident trust, with modifications not relevant to this discussion. See, e.g., N.Y. Tax Law § 618. Thus, in the case of a trust that distributes all of its net income currently, the state tax bill, like the federal tax bill, will likely be modest because the trust will receive a deduction for distributed income. Code §§ 651, 661. But such a trust will, typically, pay income tax on its capital gain. Code § 643(a)(3).

In contrast, if it is expected that the trust will accumulate income, then its state income tax bill, like its federal income tax bill, will likely be much more significant. In this case, creating a trust that is deemed a resident by more than one state could be a very costly mistake.

To properly navigate the state income taxation of trusts, it is important to determine how the states with connections to the trust determine trust residency. Once this is done, the attorney should review the trust terms, likely trustees, and the trust property to determine whether there

is a risk of multiple taxation and whether complete avoidance of state income tax is possible. For example, if the client is deciding whether the trustee should be her Arizona resident son or her New York resident daughter, the client should be made aware that choosing her Arizona resident son could subject the trust to taxation by Arizona. Ariz. Rev. Stat. § 43–1301(5).

Because most clients will, presumably, be reluctant to relocate solely to change the residence of a trust they plan to create, it may be difficult to manipulate trust residency in states that use the residence by birth method. In some cases, however, it may be possible. For example, a Connecticut resident, considering creating an irrevocable trust shortly before she retires to Florida, could be advised that creating the trust after she becomes a Florida resident could be advantageous. (Of course, if the trust is created while the settlor is a Connecticut resident, the trust will be taxed as a Connecticut resident trust. Florida, in contrast, does not impose an income tax.)

In states that use the residency by birth method, the attorney may be able to arrange the trust to take advantage of the constitutional limitations discussed above. For example, if a New Jersey resident client plans to create an irrevocable trust for the benefit of her children—only one of whom is a resident of New Jersey—it may be wise to create a separate trust for the one New Jersey resident beneficiary. In that case, the trust created for the benefit of the New Jersey resident beneficiary would be deemed a New Jersey resident trust (because the settlor is a New Jersey resident) and taxed on all of its income by New Jersey. N.J. Stat. Ann. § 54A:1–2. In contrast, the trust created for the nonresident beneficiaries would still be classified a New Jersey resident trust; however, assuming no other current connection between New Jersey and the trust, New Jersey would be constitutionally barred from taxing the trust. *Pennoyer v. Taxation Division Director,* 5 N.J. Tax 386 (1983); *Potter v. Taxation Division Director,* 5 N.J. Tax 399 (1983). Thus, by altering the client's estate plan from one New Jersey resident trust with resident and nonresident beneficiaries to two New Jersey resident trusts—one with a resident beneficiary and one with no current connection to New Jersey—the client's trusts should partially avoid taxation by New Jersey.

After the trust has been created, it is still possible to minimize (or avoid entirely) state income taxation. For example, if the trust is deemed to be an Arizona resident trust solely because one of the trustees happens to be an Arizona resident, that trustee could be encouraged to resign. Of course, unless the trust agreement provides otherwise, it seems unlikely that the beneficiaries could remove the trustee solely to minimize the state tax burden.

In states that use the residence by birth method, severing all current connections between the trust and the state of residency may allow the trust to escape taxation. For example, as mentioned earlier, in *Westfall,* the Missouri Supreme Court held that the trust's small parcel of Missouri real property was a sufficient current connection to allow Missouri to tax the trust on all trust income. 812 S.W.2d at 513. In contrast, if the trust did not own the Missouri real property, Missouri would not have been able to constitutionally tax the trust. *Swift v. Director of Revenue,* 727 S.W.2d 880 (Mo. 1987). It seems likely that the trustees in *Westfall* would have been well advised to sell the Missouri real property (assuming they were permitted to do so by the trust agreement) to avoid Missouri state income taxation.

Conclusion

State income taxes are frequently overlooked by estate planning attorneys when creating trusts; however, this oversight is potentially quite costly. Because of the variety of ways that states determine trust residency, failure to carefully navigate the laws of the states with connections to the trust could lead to multiple state taxation. Although some states provide credits for income taxes paid to other states, these credits do little to ameliorate the risk of multiple taxation caused by multiple residencies.

Along with the risk of multiple state taxation is the possibility that even a trust with connections to a variety of states that impose an income tax could completely escape state income taxation if the trust is aligned just so. To navigate these waters, the attorney must be familiar with the law of the various states. Armed with this understanding, a skilled estate planning attorney may be able to help clients' trusts completely avoid state income taxation by adjusting the connections between trust and state, regardless of whether the client is in the planning stage or the trust was created long ago.

The potential for costly multiple taxation coupled with the possibility of completely avoiding state income taxation determines the stakes. They can be enormous. ■

Joint revocable trusts have been used historically as a mechanism for married persons to combine assets and control their disposition in a uniform manner. Estate planning attorneys in community property jurisdictions routinely have drafted joint revocable trusts to take advantage of the unique "double basis" benefit of community property on the death of the first spouse under Code § 1014(b)(6), which "steps up" the basis of the entire property, even though only one-half of the property is included in the predeceasing spouse's estate for estate tax purposes. In noncommunity property jurisdictions, joint revocable trusts are being used increasingly to facilitate full use of the federal applicable exclusion amount regardless of which spouse is the first to die, particularly when the combined assets of the marital unit exceed the federal applicable exclusion amount but the individual assets of one spouse or both spouses do not meet or exceed the federal applicable exclusion amount. In TAM 9308002, the taxpayers in a common law jurisdiction attempted to get a full "step-up" in basis, similar to the treatment received in community property. The IRS denied the full "step-up" in basis based on Code § 1014(e). Similar joint revocable trusts in common law jurisdictions were discussed in two private letter rulings, PLR 200210051 and PLR 200101021. Although the IRS maintains that Code § 1014(e) prevents a full "step-up" in basis, the joint trust has favorable results for funding a credit-shelter trust on the death of the first spouse to die. At a recent Philadelphia Estate Planning Council meeting, Professor Jeffrey N. Pennell commented that the IRS will most likely write a revenue ruling in the next two years giving more guidance in the area.

Joint Revocable Trusts

New Flexibility in an Old Form

By Beth A. Turner

This article reviews the utility of a joint revocable trust that creates a credit shelter trust equal to the maximum federal applicable exclusion amount and a residuary marital trust for the balance on the death of the first spouse to die. It addresses a variety of gift, income, and estate tax issues and offers some practical drafting and administration advice. For a detailed analysis of a variety of other joint trust applications, see John H. Martin, *The Joint Trust: Estate Planning in a New Environment*, 39 Real Prop. Prob. & Tr. J. 275 (2004).

Terms of Sample Joint Revocable Trust

Although a myriad of provisions may be incorporated to customize a joint revocable trust, including variations on the general powers of appointment granted to the predeceasing spouse, for purposes of this article the following terms will be deemed to control the joint revocable trust (JRT). Husband and wife will be the sole grantors and sole co-trustees of the JRT. Each will contribute 50% of the assets to the JRT, consisting of property currently held as tenants by the entirety and individually. To equalize individually held assets, such as a marketable securities account, up to 50% of the asset will be transferred to the other spouse's individual name, and 50% of such asset will be held in each of two separate accounts, one in the name of each spouse, and then the husband and wife will contribute their equal separate accounts to the JRT. The JRT may be amended during the joint lifetime of the husband and wife only by unanimous consent. Each spouse, however, will be given the power to terminate the trust at any time before the death of the first of them to die and to have 50% of the JRT assets returned at that time to each spouse. During the joint lifetime of the husband and wife, the trustees will be authorized to distribute income and principal to either or both of the grantors in the trustees' sole discretion or as directed by an instrument executed by both of the grantors.

On the death of the first spouse (the "predeceasing spouse"), he or she will have a general testamentary power of appointment over the entire JRT assets allowing the predeceasing spouse to appoint the entire trust property to or among himself or herself, to his or her creditors, to his or her estate, or to the creditors of his or her estate. The trust becomes irrevocable on the death of the predeceasing spouse. A credit shelter trust (the "Family Trust") will be funded on the death of the surviving spouse with assets equal to the maximum federal applicable exclusion amount then in effect (currently $1.5 million, but scheduled to increase to $3.5 million by year 2009) based on a fractional formula (after taking into consideration any taxable lifetime gifts). The spouse who survives the predeceasing spouse (the "surviving spouse") will be the primary beneficiary and sole trustee of the Family Trust, and the children of the grantors will be secondary beneficiaries of the Family Trust. Distributions from the Family Trust will be limited to an ascertainable standard (health, support, maintenance, and education, for example). On the death of the surviving spouse, he or she will have a limited power of appointment over the remaining Family Trust assets and may appoint the remaining trust assets to or among the common descendants of the original grantors. Any Family Trust property not so appointed by the surviving spouse will be distributed outright to the common descendants of the initial grantors who are then living, per stirpes. It should be noted that this JRT could be drafted to incorporate trusts for children and generation-skipping transfer tax trusts.

The balance of the JRT assets not used to fund the Family Trust will be held in a marital trust for the sole benefit of the surviving spouse (the "Marital Trust") qualifying for the federal estate tax marital deduction. The surviving spouse will be the sole trustee of the Marital Trust. Income will be paid at least quarter-annually and principal will be payable in the trustee's discretion. The surviving spouse will have a testamentary general power of appointment over the Marital Trust assets. Again, any Marital Trust property not so appointed by the surviving spouse will be distributed outright to the common descendants of the initial grantors who are then living, per stirpes.

Gift Tax Issues on Funding and Until Death of Predeceasing Spouse

Treas. Reg. § 25.2511–2(b) provides that a gift is complete as to any property, or part therein, of which the

Beth A. Turner is a member in the Charlotte, North Carolina, office of Moore & Van Allen PLLC.

Ariel Skelley/CORBIS

donor has so parted with dominion and control as to leave him or her no power to change its disposition, whether for his or her own benefit or for the benefit of another. Treas. Reg. § 25.2511–2(c), however, provides that no gift is complete when a donor reserves the power to revest the beneficial title to the property to himself or herself. Under the sample JRT, because each grantor retains the power to terminate the JRT and have 50% of the JRT assets returned to each spouse, there is no completed gift on funding of the JRT by either spouse.

Until the death of the predeceasing spouse, any distribution from the JRT, including the distribution of the JRT assets on the termination of the trust, will result in a completed gift from the nonrecipient spouse to the recipient spouse to the extent that the property received in the distribution was not property contributed to the trust by the recipient spouse. The gift will, however, qualify for the gift tax marital deduction under Code § 2523.

Gift and Estate Tax Issues on Death of Predeceasing Spouse

The trust becomes irrevocable on the death of the predeceasing spouse. Under both previously cited private letter rulings, immediately preceding the death of the predeceasing spouse there is a completed gift from the surviving spouse to the predeceasing spouse of all of the JRT property that is eligible for the gift tax marital deduction. This deemed gift is relevant as it is essential that the predeceasing spouse be the transferor of all assets used to fund the Family Trust to counter any assertion that the surviving spouse was a transferor of such assets, thus causing inclusion of the assets in the surviving spouse's estate on his or her subsequent death. Furthermore, transfers from the Family Trust to beneficiaries other than the surviving spouse (children and grandchildren, for example) will not be deemed to be gifts from the surviving spouse to such other beneficiaries. Finally, the Family Trust assets will not be included in the surviving spouse's gross estate provided that a prohibited interest is not retained by the surviving spouse in the Family Trust (the surviving spouse will not be given a general power of appointment over the Family Trust assets and distributions to the surviving spouse will be limited by an ascertainable standard).

For estate tax purposes, the entire value of the JRT assets are included in the gross estate of the predeceasing spouse under Code §§ 2038 and 2041. Code § 2038(a) provides in part that the value of the gross estate of a decedent includes the value of all property of which the decedent at any time has made a transfer (except in the case of a bona fide sale for adequate and full consideration) when the enjoyment thereof was subject at the date of death of the decedent to any change through the exercise of a power by the decedent to alter, amend, revoke, or terminate the interest or when the decedent has transferred such power within three years of his or her death. Under the sample JRT, each spouse is given the power to terminate the trust at any time before the death of the first of them to die and to have 50% of the JRT assets returned to each spouse. As a result, 50% of the assets will be pulled into the estate of the predeceasing spouse under Code § 2038.

The balance of the JRT assets will be included in the gross estate of the predeceasing spouse under Code § 2041, which provides that the value of the gross estate will include the value of all property to which the decedent possesses, at the time of death, a general power of appointment. Under the sample JRT, the predeceasing spouse is given the power to appoint the JRT assets to or among himself or herself, to his or her creditors, to his or her estate, or to the creditors of his or her estate. Therefore, any assets not already included under Code § 2038 will be included in the gross estate of the predeceasing spouse under the general power of appointment provisions contained in Code § 2041.

Income Tax Consequences

Code § 1014(a) provides that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent is the fair market value of the property at the date of the decedent's death (or alternate valuation date). The "step-up" in basis under Code § 1014(a) is disallowed, however, under Code § 1014(e), if appreciated property is acquired by the decedent by gift during the one-year period before the decedent's death and the property is acquired from the decedent by, or passes from the decedent to, the donor of such property. Under such scenario, the basis in the hands of the original donor is the adjusted basis of the property in the hands of the decedent immediately before the death of the decedent.

Under the terms of the JRT, the surviving spouse is deemed to make a gift of all assets to the predeceasing spouse immediately before the death of the predeceasing spouse. Therefore, only the assets contributed by the predeceasing spouse to the JRT are eligible for a basis step-up under Code § 1014(a), as the assets contributed to the JRT by the surviving spouse were not the result of a completed gift within the one-year period ending one year before the predeceasing spouse's death. Although PLR 200210051 and PLR 200101021 specifically do not address the issue of asset tracing, as a practical matter, to ensure proper step-up in basis of the assets of the predeceasing spouse, it is imperative that the origin of the assets to the JRT on funding be ascertainable. As suggested above, to the extent possible, each grantor should contribute 50% of each of the assets to the JRT. Otherwise, tracing the origins of the assets could be administratively burdensome to ensure that the maximum amount of step-up in basis is achieved on the death of the predeceasing spouse.

Although some commentators have dismissed the utility of the joint revocable trust based on the disallowance of a full step-up in basis for all of the trust assets, as occurs in community property jurisdictions, the grantors are in no worse position for having contributed the assets to a joint revocable trust as opposed to a traditional trust because, according to the previously cited private letter rulings, the permissible step-up in basis is limited to assets deemed to be held in the individual's sole name. A more aggressive stance, not substantiated by the private letter rulings, would be that all of the assets used to fund the Family Trust receive a step-up in basis on the death of the predeceasing spouse, because the assets subject to the general power of appointment of the predeceasing spouse are not returned outright to the surviving spouse but instead are held in trust for the benefit of the surviving spouse and/or descendants and the distribution of such assets is subject to an ascertainable standard.

Drafting Considerations

Although the joint revocable trust technique may not be appropriate for all clients, a great deal of flexibility can be incorporated into the trust document itself to accommodate the unique facts and circumstances of many clients. Depending on marital accord or discord, as the case may be, a joint revocable trust for tax planning purposes may be formulated granting either extremely broad or extremely narrow testamentary general powers of appointment. The Marital Trust either can be restrictive in nature or eliminated altogether by providing that assets not used to fund the Family Trust will be distributed outright to the surviving spouse. In addition, when it is desirable, successive trusts for children and/or generation-skipping transfer tax trust provisions can be easily incorporated into the overall plan. Finally, when assets were acquired in both community property jurisdictions and noncommunity property jurisdictions, it is important that the joint revocable trust be drafted to preserve the integrity of the community property assets and that such assets be identifiable.

Conclusion

The joint revocable trust is an effective tool for ensuring that the maximum federal applicable exclusion amount is used on the death of the predeceasing spouse while offering a gamut of optional language to accommodate the unique circumstances of any particular married couple. This technique should, however, be reserved for well-advised clients who have examined all of the estate, gift, and income tax implications. ■

THE MYTH OF THE ONE-YEAR WARRANTY AND OTHER CONSTRUCTION WARRANTY ISSUES

By Susan Linden McGreevy

If your memory stretches back far enough, you may recall learning in law school that a warranty is an "assurance or promise of a particular outcome upon which another party may rely." Warranties have become an ingrained, accepted part of commercial transactions in the United States, from the purchase of a toaster or a set of tires to the acquisition of corporations and shopping centers.

When it comes to the sale of goods, governed by the Uniform Commercial Code, the power of warranties is taken seriously. Two sections of the UCC, UCC §§ 2–314(1) (warranty of merchantability) and 2–315 (warranty of fitness for particular purpose), are well understood by manufacturers, who do all they can to structure their exposure through the use of "limited" warranties or disclaimers of warranties. Even these limitations and disclaimers are controlled by other sections of the UCC. Practitioners working in the product liability arena are well-versed in the nuances of implied versus express warranties, intended versus incidental beneficiaries, and the myriad of other legal issues commonly encountered in pressing or defending such claims.

Yet, for reasons not entirely apparent, in no area are warranties more misunderstood and misapplied than in the area of construction—particularly in what could be called the "Myth of the One-Year Warranty." As a result, contracts and surety bonds are improperly

---

Susan Linden McGreevy is chair of the Construction Practice Group in the Kansas City office of Husch & Eppenberger LLC.

Charles Stubbs

drafted, inappropriate insurance is required and furnished, and owners frequently end up with huge investments that are not warranted to last as long as the last set of tires they bought for their SUVs.

The "Standard" Construction Warranty

The American Institute of Architects A201 "General Conditions of the Contract for Construction" (1997) correctly states the standard construction warranty. The contractor agrees that

- materials and equipment used by the contractor will be new and of good quality unless otherwise required;
- the work will be free from defects other than those inherent in the work as specified; and
- the work will conform to the requirements of the contract documents.

A201 ¶ 3.5.1. None of this is particularly remarkable. It is, probably, the least that a purchaser of a structure would expect—that the contractor who does not live up to these minimum requirements will be in breach of warranty. The "teeth" come in what is *not* stated. Note that *there is no time limit in this paragraph whatsoever.*

How Long Does the Warranty Extend?

Reaching again back into the law school textbook, every lawyer knows that a suit for breach of a contractual warranty must be brought within the statute of limitations, as extended by the "discovery rule," or as limited by a statute of repose in a particular state. So, how long is this for a construction defect? The answer is . . . it depends.

If AIA-type language has been used, there is no one time period for warranty exposure. The exposure to suit could be for a short or a very long time. This uncertainty is because the expected useful life of some construction materials is many years longer than other materials. For example:

- carpet cannot be expected to last as long as the steel frame or block walls, and
- caulking does not have the same typical lifespan as concrete.

Similarly, the grade of material and specific application will affect the useful life:

- residential-grade HVAC equipment will not hold up as well in industrial applications, and
- asphalt on a private residential driveway will last far longer than the same material on an interstate.

All these (as well as many other) factors must be taken into account by a trier of fact (jury, judge, or arbitrator) to make the preliminary determination of how long the product should have lasted, to then decide whether the warranty was breached.

A construction buyer expects to get a substantial product that will be around a long time.

A good example of how long exposure can exist is *Business Men's Assurance Co. of America v. Graham,* 984 S.W.2d 501 (Mo. 1999). The BMA tower in Kansas City was a renowned design of the Skidmore, Owings & Merrill architectural firm, a concrete and steel exterior frame that supported a column-free interior. The tower sits on a hilltop and is a major architectural feature of the skyline. The exterior frame is a grid clad with four-foot square marble panels. The design was completed in 1960, and the construction was completed in 1963.

In 1985, some of the marble panels started to fall off, causing the entire street level to be cordoned off. In 1986, the designers were sued. Eventually, a jury found that the mechanism for attaching the panels to the concrete behind them was defective, weakening in the wind like giant paperclips until they snapped off, and that, had they been designed correctly, they would have lasted for decades. The Missouri Supreme Court found that because the owner did not discover the latent defect until after 1981, the lawsuit was timely.

Shortening the Warranty

Apart from the defendants in that suit, no one could blame BMA for being dissatisfied that its architectural monument did not last more than 20 years. We are surrounded with structures that stand for centuries, if not millennia. Whether using a "standard form" or a custom-drafted document, a construction buyer expects to get a substantial product that will be around a long time.

Yet, there is a practice among drafters of construction documents in the United States of intentionally inserting "one-year" warranty language in contracts, under the impression that this is helping their clients. The drafters have, it seems, been lulled into believing the "Myth of the One-Year Warranty." In at least half (if not more) of the construction contracts the author has reviewed over the last five years, the drafter has deliberately added language to "clarify" that the builder must stand behind its work for "one year" (or maybe two). In fact, a recent construction publication's cover article on warranties started out by saying, "It is common, even customary, for construction contracts to include a 12-month warranty of material and workmanship." *The Contractor's Express Warranty Obligation,* Construction Claims Monthly (Bus. Publishers, Inc., Silver Spring, Md.), Jan. 2004, at 1.

In specifying short warranty periods, drafters are depriving themselves and their clients of the warranty protection they would otherwise enjoy and no doubt expect. If the drafter is asked why he or she is insisting on a one-year warranty, he or she will, to a man or woman, respond that this is "standard." If pressed further, the drafter typically cannot trace his or her belief back to any hornbook law. The only conclusion this author can come to is that drafters have heard it so often that they have come to accept it without question.

Confusion over the One-year Correction Period

One likely source of the confusion over warranty periods is the inclusion in just about every commercial construction contract of a clause requiring the contractor to return to the project to repair defects discovered within one year. In the AIA A201, a one-year *correction period* is found in ¶ 12.2.2.1. That paragraph requires the owner to notify the contractor of defects and give the contractor the opportunity to fix them itself. If the owner notices such a defect within 12 months, and either does not notify the contractor, or does not allow the contractor the opportunity to make the repairs, the warranty rights for that item are waived. If the contractor does not fix the problem, the owner may do so and collect its costs from the contractor.

This one-year correction period has, somehow, come to be referred to so often as a one-year *warranty*—or, to the dismay of every contracts professor, a one-year *guarantee*—that many developers, builders, and their counsel have come to believe that one year is as long as a construction warranty should last. Frequently, this is memorialized in the document by way of a "Special Condition," or "Supplementary Condition," or it is inserted in the front-end of the project manual by a well-intentioned designer and looks something like this:

- "Contractor warrants the Project will be habitable and constructed in a good and workmanlike manner and free from defects in material and workmanship for a period of one year following the date of Substantial Completion";
- "Defective Work found to exist within the two-year warranty period shall be removed immediately and replaced in an acceptable manner."

What owner or mortgagee or bond holder of a multi-million-dollar water treatment plant, high-rise office tower, hospital, or corporate headquarters wants to learn that it has bought no more than one year's use of the structure?

Special Warranty Problems

Drafters of prime contracts should not feel alone in their unwitting gift to general contractors. Lots of other thorny warranty issues are created, ignored, or exacerbated throughout the construction document process.

Subcontracts

It would be a rare situation indeed to find a subcontract that was drafted with the terms of a specific prime contract in mind. Subcontracts are generally "canned" documents (whether a standard form or custom drafted for the contractor) and contain some type of warranty clause. As a result, the odds that the warranties in the subcontract and the prime contract will fit together are lower than the odds of being hit by a meteor. In those cases in which the owner does not shorten the warranty obligation of the general contractor, the general contractor, in its zeal to make its subcontract language crystal clear, will often bind the subcontractor to a one-year warranty, "notwithstanding any other term to the contrary in the Prime Contract."

Manufacturer's Warranties

As noted above, most manufacturers "get it." They understand UCC issues. Aware of the staggering risk-management and accounting challenges associated with decades-long warranty exposure, manufacturers of many construction products sell their wares only with limited warranties. Whether it be an air handling unit, roof membrane, caulk, UV window tint, or paint, each product's sales literature will, somewhere, define exactly what the limits of representations are and what the buyer has to do to invoke its limited rights—such as paying for transporting the goods back to the manufacturer, election of remedies, and disavowal of consequential damage.

The rub here is that contractors, nearly without exception, sign agreements with owners that include broad warranties (at least in scope or remedy if not in time) that the manufacturers will not honor. Owners who specify more expensive brands of goods out of concerns for long-term maintenance or

durability might be surprised to learn that they have only the credit and responsiveness of their prime contractor to look to and almost certainly *not* that of the big-name manufacturer.

Extended Warranties

A number of owners, particularly public highway operators and purchasers of roofing work, have begun to specify periods of time, known as "extended warranties," from 2 years to 20 years, in their contracts. Of course, frequently what these owners have done is inadvertently *shortened* and not extended their warranty term, but they at least avoid a fight over how long a product ought to last by being specific. Again, if care is not taken in the drafting, the

benefit of the extended (or at least definite) warranty can be canceled out by other inconsistent terms.

Invitations to Lawsuits

Some parties and their counsel address the potential conflicts by adding language attempting to establish an order of precedence. Sometimes this works, but often it backfires. When the contractor specifies that the subcontractor must give a one-year warranty "in addition to any other warranties elsewhere in the contract documents," but incorporates by reference only the section of the project manual setting out the specific subcontractor's scope of work into the subcontract, what warranty governs? What if the prime contract contains specific extended warranties of equipment in the technical specifications, but the subcontract contains a one-year warranty, and there is an order of precedence clause that says that in case of conflict the terms of the subcontract control?

Technical Specification Sections

Specifications are drafted by the designer and are generally never seen by counsel, yet more and more often terms with legal significance—such as warranties—creep in. It is not uncommon to see one-year warranty language in the same project manual that includes 5- and 10-year warranties of equipment in its mechanical, electrical, or roofing sections. Without a clear order of precedence clause, which one controls? What if the bidding subcontractor never saw the one-year warranty term, but only the extended warranty term—can the subcontractor limit its warranty exposure to one year?

Surety Bonds

One of the major purposes in paying for a surety bond is to have a deeper pocket around in case the contractor defaults on its obligations, including its warranty obligation. Frequently, however, the bond states on its face that it expires a year or two after completion, thus relieving the surety of any obligation to honor a longer contractual warranty. When the bond is not so restricted, if the surety is potentially on the hook for decades, what are the chances that it will agree to furnish the bond? It could not adjust its books to close out a bond and might feel obligated to hold onto its security position respecting a contractor just to protect itself. The surety market has shrunk appreciably in the last few years, and very few sureties would knowingly agree to stand behind such an open-ended obligation. What protection has the owner purchased in this case?

Note that contractor default insurance, a product that is now used in larger projects, or the similar subcontractor default insurance employed by some large contractors, generally contains a window of time for claims that may conflict with true warranty exposure.

Insurance to Cover Warranty Obligations

The world of insurance also has changed significantly for construction. Amounts and types of coverage are more limited than ever. Latent construction defects are frequently discovered as a result of a casualty such as incorrectly installed piping causing water damage or incorrectly welded steel causing roof collapse. Obviously, the insurance does not do much good if it is not in force. "Claims-made" coverage is not likely to be extended to the length of time required to respond to the full range of most warranty exposures.

Points to Consider When Drafting Construction Documents

All of the challenges discussed above can be quantified, so that all parties understand what they are getting (or not getting), and many of the "surprises" can be avoided with the assistance of knowledgeable counsel.

- When drafting a prime contract:
  —make sure that the warranty written is the one intended and that the client understands what it is giving or accepting;
  —review the entire project manual for consistency;
  —include a clear order of precedence clause to assure that the warranty wanted is the one that controls;
  —draft or review the surety bond language and insurance language; and
  —if the designer specifies equipment that is to have a particular warranty, make him or her confirm in writing with the manufacturer that it will be available.
- When drafting or reviewing a subcontract:
  —request a copy of the prime contract, and the entire project manual, to ascertain their warranty requirements and order of precedence provisions;
  —make sure the client knows whether the manufacturers of equipment it intends to use will give the warranties that are required; and
  —advise the client to ascertain whether it can furnish the bonds and insurance coverage for the term of the warranty.

With the exception of already published public bid documents, warranty issues are generally negotiable, particularly if the other party is aware that the coverage is either not available or exorbitantly expensive. Above all, a lawyer should take care not to limit the client's warranty rights inadvertently by drafting or agreeing to language for a period falling short of the client's reasonable expectation of use of the project. ■

Jose Luis Pelaez/CORBIS

The UNAUTHORIZED PRACTICE of LAW

How Transactional Lawyers Can Avoid It

By Celeste M. Hammond

Recent cases vary widely in determining whether nonlawyers' conduct in real estate transactions is held to be "unauthorized practice of law" (UPL). Beyond actually appearing in court on behalf of a litigant, no clear definition or even approach has emerged on what constitutes the "practice of law." The determination is left to state law, usually the prescription of the highest court, which leads to more variation. The role of brokers, lenders, and title companies—sometimes the same company "bundling" the respective services it offers to the buyer or seller—especially in residential sales transactions, has been the focus of administrative and judicial regulation.

Several commentators have focused on the role of the attorney in residential transactions and the role of nonlawyers in performing tasks that previously had been performed by attorneys. Professor Joyce Palomar provided an empirical study of whether home buyers and sellers are protected better when attorneys are involved in the transactions. She concluded that the evidence was insufficient to warrant a blanket prohibition against the provision of settlement services by laymen, brokers, and title companies. Joyce Palomar, *The War Between Attorneys and Lay Conveyancers—Empirical Evidence Says "Cease Fire"!,* 31 Conn. L. Rev. 423 (1999). Michael C. Ksiazek analyzed the nature of the role of the attorney under the ABA Model Rules of Professional Conduct. He argued that conveyancing, including document preparation and settlement practices, amounts to the practice of law. The danger he identified is that nonlawyers are likely to conduct real estate transactions with solely their own interests in mind. Michael C. Ksiazek, Note, *The Model Rules of Professional Conduct and the Unauthorized Practice of Law: Justification for Restricting Conveyancing to Attorneys,* 37 Suffolk U. L. Rev. 169 (2004).

The first part of this article will review recent cases that consider what conduct by laymen constitutes the unauthorized practice of law. The second part will examine recent case law that has serious implications for those who *are authorized* to practice law. Licensed attorneys, especially those involved with commercial real estate transactions, may be subject to criminal and ethical sanctions for assisting nonlawyer clients, especially title companies and lenders, in their transactional business activities. Moreover, multijurisdictional practice increasingly has become a trap for the unwary transactional attorney.

Conduct by Laymen That Constitutes the Unauthorized Practice of Law

Real estate brokers, lenders, and title companies are involved in drafting contracts and other transactional documents, disbursing funds, and

Celeste M. Hammond is a professor of law and director of the Center for Real Estate Law at The John Marshall Law School in Chicago.

conducting closings. Whether such conduct is unauthorized practice of law depends on what each jurisdiction includes in its definition of the practice of law. Although the American Bar Association Task Force on the Model Definition of the Practice of Law set out to resolve some of these questions, in August 2003 it ultimately opted not to formulate a specific rule and encouraged individual states to create their own definitions. Interestingly, the ABA Real Property Probate and Trust Law Section provided comments to the task force that argued against a uniform, model definition of what constitutes the practice of law. Among the reasons RPPT offered were the difficulty of "reconcil[ing] the diverse state rules governing the practice of law within their respective jurisdictions" and a concern about "political feasibility" if the model definition is viewed as "an attempt to define the practice of law . . . as a means of expanding the legal monopoly." Letter from Dennis I. Belcher, Chair of the Section of Real Property, Probate and Trust Law, to Arthur Garwin, Task Force on the Model Definition of the Practice of Law, American Bar Association (Mar. 3, 2003), available at www.abanet.org/rppt/section_info/upl/RPPTcomments-def-lawpractice.pdf. The investigations by and reactions of the Federal Trade Commission and Department of Justice to a "model" approach also were negative and appear to have played a part in the task force's decision. The risks are even greater for companies that have national, and even international, real estate business, because what is acceptable conduct in "lay conveyancer" states such as Virginia and Kentucky may not be acceptable conduct in a different state.

Recent Cases Holding Such Conduct Is UPL

The Ohio Supreme Court affirmed the finding of its Board of Commissioners on the Unauthorized Practice of Law that the preparation of a general warranty deed to convey property from a seller to a buyer constitutes the practice of law. *Toledo Bar Ass'n v. Chelsea Title Agency of Dayton, Inc.,* 800 N.E.2d 29 (Ohio 2003). The title company created the deed by inserting information into a deed form that had been created by an attorney, but no attorney reviewed the deed or had the opportunity to make changes. After several warnings that this practice was objectionable, a section of the Toledo Bar Association filed a complaint. The court held that preparation of deeds constituted the preparation of legal documents, which amounts to the practice of law. A fine of $1,000 and an injunction from continuing these practices were imposed on the title company.

A title company's title search and preparation of title documents for the lender constitutes the unauthorized practice of law unless a licensed attorney supervises the process.

The Supreme Court of Georgia affirmed an advisory opinion by the state bar's Standing Committee on the Unlicensed Practice of Law, confirming that it is the unauthorized practice of law for someone other than a duly licensed Georgia attorney to close a real estate transaction or to prepare or facilitate the execution of deeds for the benefit of a seller, borrower, or lender. *In re UPL Advisory Opinion 2003–2,* 588 S.E.2d 741 (Ga. 2003). The court also confirmed its prior ruling requiring the physical presence of an attorney for the preparation and execution of a deed of conveyance.

The Georgia court rejected the contentions of proponents of lay conveyancing or witness-only closings, who argue that by requiring the services of lawyers for real estate closings and the execution of deeds, it needlessly harmed the public interest by increasing the price and decreasing choice for consumers. The court distinguished a professional service from a purely commercial enterprise, holding that the attorney's foremost obligation in protecting the public's interest is met only when an attorney oversees the entire transaction. Because an attorney may be sued for malpractice or be subject to disciplinary action if he or she fails in meeting his or her responsibility, the public is more protected than if a nonlawyer failed to conduct the closing properly.

In a subsequent opinion, the Georgia Bar Standing Committee on the Unlicensed Practice of Law stated that a nonlawyer's preparation of a lien for another in exchange for a fee is the unlicensed practice of law, "while the ministerial act of physically filing a lien with a court" is not. The committee pointed to Ga. Code Ann. § 15–19–50(3), which provides that the practice of law includes "[t]he preparation of legal instruments of all kinds whereby a legal right is secured." *In re UPL Advisory Opinion 2004–1* (Ga. Aug. 6, 2004), available at www.gabar.org/programs/unlicensed_practice_of_law/upl_advisory_opinions/#2004-1.

Two decisions of the South Carolina Supreme Court clarify its position on what constitutes unauthorized practice. In *Doe v. McMaster,* 585 S.E.2d 773 (S.C. 2003), the court

confirmed the requirement that an attorney supervise all aspects of real estate transactions, including refinancing of mortgage loans. On petition by the attorney, the court reviewed his arrangement with a lender bank in refinancings in which the attorney was to oversee (1) the title search, (2) the preparation and the execution of the loan documents following a meeting with the borrower "to explain the legal ramifications of the documents and answer questions" (for which the attorney received a fee from the borrower consistent with that typically charged in refinancings), (3) the closing, and (4) the recordation of the title and loan documents. The court held that a title company's title search and preparation of title documents for the lender constitutes the unauthorized practice of law unless a licensed attorney supervises the process. Similarly, the court said the lender may prepare legal documents for use in refinancing a loan only when "an independent attorney reviews and corrects, if needed, the documents to ensure their compliance with law." In so holding, the court rejected the argument that a lender has a *pro se* right to prepare documents when it is a party. "The right of a corporation to practice law by completing real estate loan documents is not co-extensive with an individual's right."

Ex Parte Charles M. Watson, 589 S.E.2d 760 (S.C. 2003), was a response to a petition for a declaratory judgment on whether nonlawyer title abstractors engaged in UPL when they conducted a title search and reported the title status in connection with a tax foreclosure sale. The South Carolina Supreme Court ruled that such activity constitutes UPL unless an attorney conducts or supervises it. Because property owners, buyers, lienholders, and counties relied on the tax collector to notify all the necessary parties before the sale, a tax sale could be invalidated and the county subjected to claims of failure of due process if the title abstractor's report was in error. The court supposed that an attorney's supervision would be protective or at least someone could be sued for malpractice.

Recent Cases Holding Such Conduct Is *Not* UPL

The Kentucky Supreme Court rejected an advisory opinion of the Kentucky Bar Association declaring that the performance of a real estate closing by a lay closing agent constituted the unauthorized practice of law. *Countrywide Home Loans, Inc. v. Kentucky Bar Ass'n,* 113 S.W.3d 105 (Ky. 2003). In response to a request for review by a bankers' association and other entities having business exposure to closings of real estate transactions, the court differentiated between conducting closings and answering legal questions that might arise at the closing or the offering of any kind of legal advice. The court based this distinction on its view that by the time of closing, the parties had already addressed all legal issues. Moreover, the court held that when an institutional lender is a real party as mortgagee, its lay employee or in-house attorney may preside over the mortgage closing with a customer who is not represented by an attorney, but such employee, whether an attorney or not, may not provide legal advice or answers to the borrower. The court noted that although institutional lenders are not subject to the same discipline rules as attorneys, the public is protected to some degree by state and federal requirements for licensure, capitalization, oaths of directors and officers, insured deposits, and other regulations.

An Illinois appellate court, reviewing a case in which a lender prepared documents used in the mortgage transaction and charged the mortgagor a fee, certified two questions on appeal: (1) whether the act of preparing mortgage documents and charging a fee for the preparation constitutes the unauthorized practice of law and, if so, (2) whether the mortgagors have the right to seek a private remedy. *King v. First Capital Fin. Servs. Corp.,* 798 N.E.2d 118 (Ill. App. Ct. 2003). The court decided that such conduct is not UPL, so that the second question was moot. Because the mortgage documents are prepared by the lender for its own use, it is not holding itself out as a legal advisor; its acts are *pro se.* Charging a fee does not change the nature of the activity.

In *Dressel v. Ameribank,* 664 N.W.2d 151, 158 (Mich. 2003), the Michigan Supreme Court held that preparation of mortgage loan documents does not constitute the practice of law because it does not "require the use of legal discretion and profound legal knowledge." The court also stated that the preparation of deeds does not ordinarily constitute the practice of law because the

When an institutional lender is a real party as mortgagee, its lay employee or in-house attorney may preside over the mortgage closing with a customer who is not represented by an attorney, but such employee, whether an attorney or not, may not provide legal advice or answers to the borrower.

latter does not encompass "the ordinary run of agreements [used] in every day activities of the commercial and industrial world." Id. at 156. Specifically, drafting of ordinary leases, deeds, and mortgages does not constitute practicing law. The charging of a fee does not change the nature of the activity. (Perhaps this means that title companies may prepare deeds in Michigan as well.)

Although the attorney did review all of the documents before the closing, he was not present at the closing conducted by his nonlawyer assistants at which the client's wife forged her husband's signature.

Relying on the precedent in the *Dressel* case, a Michigan appellate court held that charging a $250 document fee for preparation of loan documents did not sustain a charge of UPL against the lender. *Newton v. Bank West*, 686 N.W.2d 491 (Mich. Ct. App. 2004). In a similar case, the court dismissed a charge of unauthorized practice of law when the defendant, operating as both mortgage lender and mortgage broker, charged several fees competitive with those normally charged, including fees for document preparation after release of the *Dressel* opinion. See *Lewis v. First Alliance Mortgage Co.*, No. 230089, 2004 WL 1365997 (Mich. Ct. App. June 17, 2004).

Implications for Those Who Are Authorized to Practice

Although real estate lawyers have more than a passing interest in the UPL issue as applied to the conduct of a broker, lender, or title company, there is an even greater concern for the potential charge against themselves of UPL with possible criminal or ethical penalties.

Disciplinary Actions Against Attorneys

A series of South Carolina cases illustrate the dire consequences in that state for attorneys who do not comply with the strong state policy requiring attorney involvement in all aspects of real estate transactions. The South Carolina Supreme Court ruled that an attorney who failed to supervise refinancings for a client violated the Rules of Professional Conduct and Rules for Lawyer Disciplinary Enforcement. Although the attorney did review all of the documents before the closing, he was not present at the closing conducted by his nonlawyer assistants at which the client's wife forged her husband's signature. *In re Edens*, 544 S.E.2d 627 (S.C. 2001). The court concluded that this conduct warranted a public reprimand.

In *In re Lester*, 578 S.E.2d 7 (S.C. 2003), the court disciplined an attorney who authorized a paralegal to conduct a closing in the lawyer's absence, even though the lawyer had reviewed the closing statement and other documents and was available by telephone. Likewise, the South Carolina Supreme Court held that an attorney's conduct warranted a public reprimand when the attorney failed to directly participate in a real estate closing and allowed a mortgage broker to complete the closing, thus constituting the unauthorized practice of law. *In re Spell*, 587 S.E.2d 104 (S.C. 2003). The attorney admitted that his conduct violated Rule 5.5(b), which provides that a lawyer shall not assist a person who is not a member of the bar in performance of an activity that constitutes UPL.

In *In re Foster*, 587 S.E.2d 690 (S.C. 2003), an attorney was given a public reprimand by agreement after he self-reported the ethical violation. He had permitted a nonlawyer employee to perform real estate closings in his absence and without supervision and to be responsible for reconciliation of the real estate escrow account maintained by the lawyer's firm. This unsupervised conduct had caused inaccuracies in the HUD-1 Settlement Statements in violation of the purposes of the Federal Truth in Lending Act.

In 2004, an Agreement for Discipline by Consent resulted in the disbarment of an attorney. *In re McMillian*, 596 S.E.2d 494 (S.C. 2004). The attorney had made a business arrangement with a title company to close large volumes of real estate loans. The attorney could not attend all of the closings. The title company's nonlawyer staff would conduct those closings and sign the attorney's name. As part of the arrangement, the title company's office manager had been given signatory authority over the attorney's trust accounts. Because of the attorney's failure to manage, supervise, and reconcile the accounts, substantial misappropriations and dishonored checks resulted, causing damage to clients. The parties to the disciplinary action also agreed that the attorney's conduct amounted to assisting in the unauthorized practice of law.

Multijurisdictional Practice—Wave of the Future and Trap for the Unwary Transactional Attorney

The concern over the unauthorized practice of law by laymen has focused on residential transactions. Little attention has been given to commercial real estate transactions, probably because sophisticated parties are considered to be capable of choosing whether or not to have an

attorney involved in the transaction. The rationale of the prohibition against UPL is protection of unsophisticated consumers. See Palomar, *The War Between Attorneys and Lay Conveyancers*, supra. Yet, with national and even international clients, commercial real estate lawyers may run afoul of an individual state rule by engaging in multijurisdictional practice appropriate for such clients.

A grand jury in North Carolina indicted two out-of-state Georgia lawyers and their Atlanta firm in March 2004 based on allegations of the unauthorized practice of law. The Georgia lawyers had been retained to assist a North Carolina university to investigate allegations of impropriety in a sports program. See Jonathan Ringel, *Atlanta Firm Is Indicted—Charge Is Unauthorized Practice; Issue of Serving Out-of-State Clients,* Nat'l L. J., April 12, 2004. The law firm conducted an investigation that consisted of interviews with students and university staff and issued a report to the trustees of the university in 2003, which led to the reassignment of two faculty members. A local attorney, who had been a trustee previously and whose brother was a faculty member who objected to the discipline of his colleagues, filed a complaint with the state bar and sent a copy to the local district attorney, who took the case to a grand jury. The misdemeanor indictment charged both the lawyers and their firm with the unauthorized practice of law for holding themselves out as attorneys and claiming an attorney-client privilege in the investigatory matter. It is not clear whether adoption of the ABA's new Model Rule 5.5 would have avoided this problem.

The Wisconsin Supreme Court in a very divided opinion affirmed a lower court ruling against a physician seeking a declaratory judgment that his lawyer, who was licensed only in New Jersey, could represent him in a hospital review hearing. *Seitzinger v. Community Health Network,* 676 N.W.2d 426 (Wis. 2004). The doctor argued unsuccessfully that his lawyer did not need a Wisconsin license because the peer review hearing was not a judicial proceeding. He argued alternatively that if the hearing were a judicial proceeding, his lawyer should have been admitted *pro hac vice.* The trial court held that, as a matter of interpreting the doctor's contract with the hospital, "legal counsel" in the hospital bylaws meant a lawyer licensed in Wisconsin. In so ruling, the court found it unnecessary to review the trial court's determination that the

The concern over the unauthorized practice of law by laymen has focused on residential transactions.

New Jersey attorney's representation would constitute UPL.

Although the ABA has adopted the recommendation of its Commission on Multijurisdictional Practice (MJP) to amend the Model Rules of Professional Conduct to enable lawyers more freely to provide legal services in states where they are not licensed, it remains for the individual states to adopt the new rules and to do so uniformly. See George A. Riemer, *A State of Flux: Trends in the Regulation of Multijurisdictional Practice of Law,* 64 Or. St. B. Bull. 19 (Aug./Sept. 2004). Arizona, California, Colorado, Georgia, Idaho, Indiana, Missouri, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Pennsylvania, and South Dakota have adopted versions of Rule 5.5, but the adopted laws vary significantly from the Model Rules. Id. Arkansas, Delaware, Iowa, Maryland, and Oregon have adopted versions that are identical to the ABA version. These deviations portend a variety of rules, rather than a uniform standard, as other states consider adoption. Moreover, Rule 5.5 gives protection in nonlitigation matters only "on a temporary basis" and only if such legal services "arise out of or are reasonably related to" the lawyer's practice in the jurisdiction where the attorney is licensed or "are undertaken in association with a lawyer who is admitted to practice in [the] jurisdiction and who actively participates in the matter."

A contemporaneous amendment to Model Rule 8.5 provides that an attorney is subject to discipline in any state where the attorney renders legal services, even if the attorney is not admitted in that state. Thus, to avoid this UPL trap, transactional lawyers must be cautious and consider using, or continue the practice of using, a local counsel who "actively participates" in the transaction when providing legal services in jurisdictions where they are not admitted. ■

Opportunities and Pitfalls with Non-Pro Rata Distributions to Residuary Beneficiaries

By John W. Randolph Jr. and Jennifer Gurevitz

From both tax and administration perspectives, attorneys need to be aware of the potential opportunities and pitfalls of making non-pro rata distributions to estate and trust residuary beneficiaries. Residuary beneficiaries are those beneficiaries who receive the assets of the estate or trust after all debts, administrative expenses, taxes, and pre-residuary distributions are made. By way of background, the common law rule is that distributions to estate and trust residuary beneficiaries are to be in kind and pro rata. This means that in closing out an estate or terminating a trust, the fiduciary should not sell remaining estate or trust assets and distribute cash to the residuary beneficiaries. Instead, the residuary beneficiaries should receive the remaining estate or trust assets in kind on a pro rata (proportionate) basis.

For instance, assume a will makes a residuary gift equally to two individuals. The estate holds 400 shares of IBM stock and a parcel of land. The personal representative should, under the common law rule, distribute 200 shares of

---

John W. Randolph Jr. practices with Pressly & Pressly, P.A., in West Palm Beach, Florida. Jennifer Gurevitz is a graduate tax law student at New York University.

IBM stock and an undivided one-half interest in the land to each beneficiary. Under the common law rule, the personal representative cannot sell the shares and distribute the cash, nor can the personal representative distribute a disproportionate mix of stock and land among the beneficiaries.

If a fiduciary deviates from in-kind, pro rata distributions, he or she may face surcharge liability and may trigger beneficiary tax liabilities. On the other hand, non-pro rata distributions may be more practical, enhance asset value, promote charitable tax planning, be preferred by the beneficiaries, and perhaps reduce taxes.

Analysis of In-kind and Pro Rata Rules

In-kind Distributions

Uniform Probate Code (UPC) § 3–906(a) codifies the common law in-kind distribution requirement. This section provides that unless a contrary intention is indicated by the will, the distributable assets of an estate shall be distributed in kind to the extent possible. The UPC commentary for this section states: "[t]his section establishes a preference for distribution in kind. It directs a personal representative to make distribution in kind whenever feasible and to convert assets to cash only when there is a special reason for doing so."

By making an in-kind distribution, the residuary beneficiaries decide whether to sell or retain the distributed assets, not the fiduciary. Further, a fiduciary's sale of residual assets, just before distribution, may result in unwarranted tax liabilities passing to the beneficiaries. The general rule is that there is no tax gain or loss to the estate, trust, or residuary beneficiaries in connection with an in-kind distribution of assets. Rather, the gain or loss is recognized on a later sale by a beneficiary. Thus, the sale of residuary assets can unnecessarily accelerate the payment of income tax.

UPC § 3–906(a) contains the caveat that in-kind distributions are required "to the extent possible." For instance, a fiduciary does not have to distribute in-kind real estate to residuary beneficiaries who do not get along. In this case, the personal representative should have the authority to sell the real estate and distribute the net sale proceeds. As is discussed below, state law or the governing instrument can authorize non-pro rata distributions in lieu of sale. In the prior example, if the personal representative is authorized to make non-pro rata distributions, then the estate's real estate could be distributed to one beneficiary, with other assets, equal in value to the real estate, distributed to the other beneficiary.

Pro Rata Distributions

The common law rule mandating pro rata asset distributions assures that the residuary beneficiaries each receive their economic proportionate share of the estate or trust. For instance, under this rule, two 50% residuary beneficiaries are assured equal economic treatment because they each receive their proportionate share of each estate or trust asset. This is consistent with the fiduciary duty to act impartially in administering an estate or trust with two or more beneficiaries. See, e.g., Uniform Trust Code (UTC) § 803.

UTC and the UPC have modified this common law pro rata distribution rule. UTC § 816(22) provides trustees with the power to allocate particular assets in proportionate or disproportionate shares among beneficiaries, to value the trust property for these purposes, and to adjust for resulting differences in value. UPC § 3–906(a)(4) directs distribution of the residuary estate "in any equitable manner."

Why did the Uniform Law Commissioners alter the pro rata common law rule? The commentary to UTC § 816(22) states that the power to make non-pro rata distributions "provides needed flexibility and lessens the risk that a non-pro rata distribution will be treated as a taxable sale." Interestingly, the UPC commentary states that "each residuary beneficiary's basic right is to his proportionate share of each asset constituting the residue." On its face this commentary seems to conflict with UPC § 3–906(a)(4) allowing for distributions "in any equitable manner." The authors believe, however, that this commentary stands for the proposition that each residuary beneficiary can receive other than a pro rata asset distribution, but that each beneficiary must receive economically what he or she would have received had he or she received his or her proportionate share of each estate or trust asset.

Practitioners should look to state law to determine whether non-pro rata distributions are authorized. Not all states have adopted the UPC and UTC and, even if adopted, uniform acts are often not adopted in full. Also, it cannot always be assumed that, if a state's probate code authorizes non-pro rata distributions, its trust code will do the same (and vice versa).

Attorneys should also review the governing instruments to determine the scope of the fiduciary's power to make distributions to residuary beneficiaries. In general, governing instrument provisions take precedence over the general powers set forth in state probate and trust codes. For instance, as mentioned, UPC § 3–906(a) begins by stating, "[u]nless a contrary intention is indicated by the will . . . ." Thus, the governing instrument may explicitly preclude the power to make non-pro rata distributions. In this case,

Non-Pro Rata Distribution Provision

To afford the fiduciary with maximum flexibility, the following sample governing instrument provision authorizes cash or in-kind distributions as well as non-pro rata distributions:

> The personal representative (or trustee, as applicable) is authorized to distribute income and principal in cash or in kind, or partly in each, and to allocate or distribute undivided interests or different assets or disproportionate interests in assets, and to value the property for those purposes, subject to the fiduciary's duty of impartiality.

Andrew O. Alcala

the fiduciary could not make non-pro rata distributions. If a governing instrument is silent, then the powers set forth in the state probate and trust codes would apply. To guard against state law failing to provide authority to make non-pro rata distributions, attorneys drafting wills and trusts should include a provision authorizing the fiduciary to make non-pro rata distributions (see box on page 61).

Opportunities with Making Non-Pro Rata Distributions

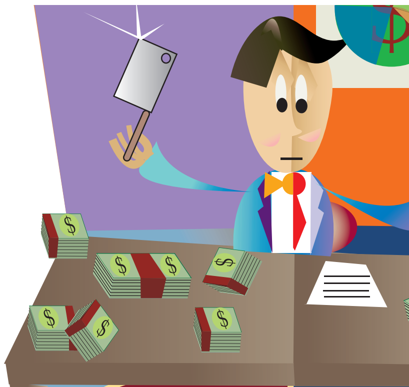
Non-pro rata distributions can reduce beneficiary income taxes, foster charitable planning, alleviate the necessity to cause distributions of fractional interests in assets, enhance asset value, avoid the difficulties surrounding distribution of uneven lots of assets, and allow for the distribution of a particular asset desired by a beneficiary. The following examples highlight some of the potential benefits of non-pro rata distribution.

Non-pro rata distributions can also be used to address nontax issues posed by unique assets.

Charity and Individual as Residuary Beneficiaries

One example of a non-pro rata distribution would be when a charity is a residuary beneficiary. For example, assume that the trustee is in the process of distributing the balance of the trust assets to the residuary beneficiaries on the death of the income beneficiary. There are two equal residuary beneficiaries, Child and Charity, a tax-exempt organization. The trust holds $500,000 of cash and a $500,000 portfolio of marketable securities with an income tax basis of $200,000. If the trustee did not have the power to distribute the assets non-pro rata, the trustee would have distributed $250,000 of cash and a $250,000 portion of the marketable securities portfolio to Child. If Child were to immediately sell these securities, the sale would trigger $150,000 in capital gains, triggering a capital gains tax. If, however, the trust or state law authorized the trustee to make non-pro rata distributions and the trust did not prohibit non-pro rata distributions, Child could receive the $500,000 of cash and Charity the $500,000 portfolio of securities. Charity could then sell the securities without incurring any income tax because it is tax-exempt.

Similarly, non-pro rata distributions can result in a charitable income tax deduction for the income beneficiary of a trust. See, e.g., PLR 200438028. In this ruling, the decedent's will established a



trust for her spouse ("Marital Trust"). The spouse received all of the income from the Marital Trust and principal for his support and medical care. At the surviving spouse's later death, certain designated persons and organizations received specific tangible personal property with a tax-exempt Charity ("Charity") named as the recipient of the balance of the Marital Trust assets. In the estate of the first spouse to die, the executor elected to treat the entire Marital Trust as qualified terminable interest property under Code § 2056(b)(7). In the ruling, the surviving spouse, as trustee of the Marital Trust, proposed to sever the trust into two Marital Trusts with a non-pro rata funding of primarily the tangibles into "Trust 1" and a funding of all other assets into "Trust 2." The spouse then proposed to assign his income interest in Trust 2 to Charity. The spouse requested a ruling that the assignment of his interest in Trust 2 to Charity provided him with an income tax charitable deduction, based on the actuarial value of his interest in the trust. In reaching its ruling, the IRS analyzed Code § 170(f)(3)(A), which disallows a charitable income tax deduction for a contribution of a partial interest in property. At issue was the potential application of Code § 170(f)(3)(A) if the severed trusts were funded on a pro rata basis with fractional interests in property. The IRS noted that "[s]pouse represents that in the course of the property division of the trust, he will not divide any assets in the Marital Trust into fractional interests." The spouse was able to make this representation in that he proposed to fund the severed trusts on a non-pro rata basis. As a result of the spouse's representation that he would not fund the severed trusts with pro rata interests, the IRS ruled that he was entitled to an income tax charitable deduction for his assignment.

Beneficiaries' Selection of Assets

Non-pro rata distributions can also be used to address nontax issues posed by unique assets. For example, an estate might include a personal residence and securities. The personal representative wishes to make final distributions from the estate to the equal residuary beneficiaries, Daughter and Son. Daughter and Son informed the personal representative that Daughter would like a distribution of the residence while Son prefers a distribution of securities. If state law or the will provides the personal representative with the power to make non-pro rata distributions and the will does not prohibit non-pro rata distributions, the personal representative may abide by the beneficiaries' wishes by distributing the residence to Daughter and an equal amount of the securities to Son. The personal representative would then divide the remainder of the securities between Daughter and Son. Without this power, the personal representative would have had to distribute equally the residence and securities between Daughter and Son, with the result being that Daughter and Son would then own the residence as tenants in common.

Owning real estate as undivided tenants-in-common is problematic

because neither co-tenant absolutely controls the property. The interest of each co-tenant can be conveyed, encumbered, or devised to a third party, and is subject to attachment to pay the debts of a co-tenant. In addition, each co-tenant has a right to a partition, resulting in the division of the property or its forced sale. For these reasons, the fair market value of a fractional tenant-in-common interest in real estate does not equal an equivalent proportion of the market value for the entire parcel. For instance, if a parcel of real estate has a total fair market value of $100,000, the value of a 50% interest as a tenant-in-common does not equal $50,000. The value of the interest is discounted to take into account the disadvantages of co-ownership. For instance, in *Estate of Forbes v. Commissioner*, 81 T.C.M. (CCH) 1399 (2001), the Tax Court held that a fractional interest in real property was worth 30% less than its percentage of the fair market value of the entire parcel. A trustee, in making residuary distribution, should consider making a non-pro rata distribution of this real estate to one of the beneficiaries with a distribution of other trust assets equal in value to the real estate to the other beneficiary. To do otherwise would result in each beneficiary receiving assets having a fair market value less than the beneficiary would have received through the described non-pro rata distributions.

Pitfalls with Making Non-Pro Rata Distributions

There are many traps for the unwary when it comes to making non-pro rata asset distributions to residuary beneficiaries. These traps include (1) the potential for distribution to be treated as a taxable exchange among beneficiaries, (2) the possibility that an individual beneficiary may be subject to tax on assets received by a charitable beneficiary, or (3) the problem that distributions will not be economically proportionate. These traps could subject a fiduciary to a surcharge action. In addition, a beneficiary may be disappointed in receiving assets that are different from those received by other beneficiaries. One example may be a distribution of an item of "income in respect of a decedent" (IRD) such as decedent's individual retirement account. Generally, under Code §§ 691 and 1014(c), the death beneficiary of the individual retirement account inherits the decedent's zero basis in the account and distributions to the beneficiary are fully subject to income tax. In comparison, marketable securities distributed from an estate have basis, generally equal to their fair market value on decedent's date of death, under Code § 1014(a). Income tax is triggered only if the beneficiary later sells the securities for greater than this basis. Thus, the residuary beneficiary who receives IRD may receive assets with the same value, but subject to an income tax burden. As a result, equal

residuary beneficiaries receive disproportionate economic amounts.

Tax Trap of Rev. Rul. 69–486

What would happen if a fiduciary made non-pro rata distributions without the power to do so under either state law or the governing instrument? In Rev. Rul. 69–486, the trust instrument required the trustee to distribute at the decedent's death one-half of the trust corpus to C, an individual, and one-half to X, a charity. The trust instrument and local law were both silent on the authority of the trustee to make a non-pro rata distribution of property in kind. The trust contained note obligations and common stock. The beneficiaries requested that the trustee distribute all of the notes to C, the individual, and all the common stock to X, the charity, and the trustee complied. The IRS ruled that because the trustee was not authorized under either state law or the governing instrument to make a non-pro rata distribution of property in kind, the distribution should be treated as equivalent to a taxable exchange. The transaction was characterized as a distribution to C and X of the notes and common stock pro rata by the trustee, followed by an exchange between C and X of C's pro rata share of common stock for X's pro rata share of notes. As a result of this exchange C, an individual, recognized a gain from the appreciation of the common stock since the trust's date of acquisition. X would recognize a gain; however, as a charity, no tax was due.

Individual Retirement Accounts (IRAs)

IRAs can pose unique problems when making non-pro rata distributions. For

A beneficiary may be disappointed in receiving assets that are different from those received by other beneficiaries.

example, assume that a will gives the residue of an estate equally to Charity and Child. The estate assets available for distribution consist of a $500,000 traditional (non-Roth) IRA and $500,000 of cash. The IRA consists of a portfolio of marketable securities. As discussed above, an IRA is IRD property, which

means the securities held in the IRA have a zero basis. In an effort to avoid Child having to pay tax on distributions from the IRA, the personal representative devises a plan to distribute the IRA's securities to Charity. Accordingly, the IRA securities are distributed to the estate and the personal representative immediately distributes these $500,000 of securities to Charity. On the same date, the personal representative distributes the $500,000 of cash to Child.

Even if the will or state law authorizes the described non-pro rata distributions, Treas. Reg. §1.663(c)–2(b)(3) requires the estate to allocate gross income among the beneficiary's shares of the estate proportionately. As a result, a $250,000 portion of the IRA distribution would be allocated to Child's share of the estate. This means that Child would have to report this as gross income on Child's federal income tax return.

In PLR 200234019, the tax professionals advising the personal representative appeared to be aware of this potential tax pitfall. In the ruling request, the personal representative proposed to assign the IRA directly to charity without any portion of the IRA being distributed directly to the estate. Significantly, the decedent's will authorized non-pro rata and in-kind distributions. The IRS ruled that the assignment of the IRA was not taxable income to the estate (because it never received these proceeds from the IRA) nor to the individual beneficiary. The IRA proceeds were income to the charity, but the distribution was not taxable because the charity was tax exempt.

From a drafting perspective, another approach to preventing the individual beneficiary from being subject to tax in these instances would be to insert a provision in the governing instrument requiring the fiduciary first to distribute the IRA proceeds (or other items of IRD) to the charitable share of the residue. In that case, the regulations allocate the IRA income to this charitable share. Treas. Reg. § 1.663(c)–5, ex. 9.

Disproportionate Economic Value

A and B, equal trust residuary beneficiaries, do not get along. The trust assets consist of land and $200,000 of cash. Because A and B are not cordial with each other, the trustee distributes the land to A along with $20,000 of cash and distributes $180,000 of cash to B. Just before the distribution, the trustee obtained an appraisal on the land, valuing it at $160,000. A few weeks after receipt of the land distribution, A sells the land for $500,000. B learns of this sale and immediately files suit against the trustee for the breach of the duty of impartiality. In an apparent effort to reduce trustee exposure to a post-distribution lawsuit, UTC § 817(a) allows a trustee to send to the beneficiaries a proposal for trust termination distributions. The beneficiaries have 30 days to object to the proposed distribution.

Conclusion

In counseling fiduciaries making distributions to residuary beneficiaries, attorneys should discuss non-pro rata distributions. An attorney should point out to the fiduciary the benefits of making non-pro rata distributions, such as reducing beneficiary income taxes, fostering charitable planning, alleviating the necessity to cause distributions of fractional interests in assets such as real estate, enhancing beneficiary asset value, avoiding the difficulties surrounding distribution of odd lot securities (such as 103 shares of IBM stock), and allowing for the distribution of a particular asset desired by a beneficiary. At the same time, however, fiduciaries must understand the numerous pitfalls that can arise with making non-pro rata distributions. These pitfalls include recharacterization as a taxable exchange among beneficiaries, the potential for an individual beneficiary to be subject to income tax on assets received by a charitable beneficiary, and the possibility that distributions will not be economically proportionate, whether because of improper valuation or varying tax bases of the distributed property. Many of these potential pitfalls could be avoided altogether or mitigated by advance planning and the use of appropriate language in the governing instruments. ■

AD Index

Advertiser	Page	Contact
ABA Real Property, Probate and Trust Law Section Books and Videotapes	9,15	www.ababooks.org
Advent Oil	59	1-720-939-1414 www.oil@att.net
Appraisal Institute	29	www.appraisalinstitute.org/lawyer
The Bar Plan	51	877-553-6376 www.americanbarinsurance.onlinecourtbonds.com
Bessemer Trust	25	www.bessemer.com
Chicago Title	BC	www.ctic.com
Core Funding Group, LP	21	1-800-836-0479
Council on Foundations	IFC	www.communityfoundations.net
Hertz	IBC	1-800-654-2210 www.hertz.com
Incavo Appraisals	40	www.incavoappraisals.com
International Genealogical Search	39	1-800-663-2255 www.heirsearch.com
Josh Butler & Co.	63	1-800-567-8434 www.lostheir.com
Net Lease Capital Advisors	33	www.netleasecapital.com
Thomson West	7	1-800-762-5272 www.west.thomson.com/westlaw/practitioner