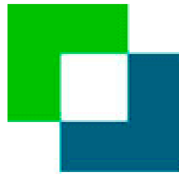

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

eReport

A Bi-Monthly Electronic Publication for Section Members APRIL 2008

Section News

It is not to late to register for the spring symposia!

Join the RPTE Section of as we hold our 18th Annual Spring Symposia May 1-2 in Washington D.C. Noted speakers and experts in the fields of real estate and estate planning will lead programs on current issues and hot topics. All sessions will be held at the Park Hyatt and Fairmont hotels. Take this opportunity to earn CLE credit while networking with colleagues and learning about the Section's activities and news. Come explore the great city of Washington D.C.!

On-site registration will be held from 1:00 to 5:00 p.m. on April 30 and from 7:00 a.m. to 5:00 p.m. on May 1 and 2 at the Section desk at the Fairmont Hotel. For more registration details visit www.abanet.org/rppt/2008. For more program information, click here.

Trust and Estate News Real Property News

Real Property News

NEW CHANGES TO IRC RULES ON VACATION-SECOND HOMES AND 1031 EXCHANGES

By Stephen Wayner

A 1031 exchange may allow a taxpayer to shield from taxes gain on the conveyance of a vacation home. A new Revenue Procedure clarifies when a vacation home will constitute property held for productive use in a trade or business or for investment, so as to qualify for a 1031 exchange. In his article, Stephen Wayner provides guidance on this new Revenue Procedure.

REAL ESTATE TRANSFER ON DEATH DEEDS

By Dennis Horn

The National Conference of Commissioners on Uniform State Laws (NCCUSL) has appointed a Drafting Committee to propose uniform legislation to authorize transfer on death deeds of real property. The Section has appointed Dennis Horn as our ABA Section Advisor and an ABA Advisor to the NCCUSL Drafting

Technology

Online Collaboration Tools: Smarter Ways to Work Together

By Tom Mighell

Collaboration has always been a necessary aspect of a lawyer's practice. Now there are tools to collaborate electronically. Click here to learn about tools to make your practice more productive.

Upcoming CLE Programs

TRUST AND ESTATE CLE

Frying Pans and Fires? Or Prospects Not So Dire?: Hot Topics in Family Limited Partnerships
Date: Thursday, May 1, 2008
Time: 10:45 a.m. to 11:45 a.m. Eastern
Place: Fairmont Hotel - Ballroom II

REAL PROPERTY CLE

Has the Earth Stopped Shaking? The State of the Commercial Financing Markets Since the Subprime Meltdown
Date: Friday, May 2, 2008
Time: 1:45 p.m. to 3:15 p.m. Eastern
Place: Fairmont Hotel - Executive Forum Room

Group & Committee News

TRUST AND ESTATE

Commission on Law and Aging

The ABA Commission on Law and Aging is seeking funding from the ACTEC Foundation, the Uniform Law Commission Foundation and the RPTE Section for outreach and education on the Uniform Adult Guardianship and Protection Proceeding. The proposal will be reviewed at the Trust and Estate Subcouncil meeting in Washington, D.C. on May 3, 2008.

Committee. Dennis has provided an initial report on the committee and invites comments from Section members.

Trust and Estate News

PROTECT YOUR PET'S FUTURE
PET TRUSTS AND PET PROTECTION AGREEMENTS
By Rachel Hirschfeld

Mirowski v. Commissioner
By Steve Akers
T.C. Memo. 2008-74; Court Rejects IRS's §§2036(a)(1), 2036(a)(2), 2038, and 2035 Arguments

Supreme Court Rules Participants & Beneficiaries Can Sue Fiduciaries Under ERISA §502(a)(2) To Recover 401(k) & Other Defined Contribution Account Losses: "Entire Plan Rule" Limited To Plans With Fixed Benefit Formula
By Cynthia Marcotte Stamer

First Report to the ABA of the Proceedings of the NCCUSL Drafting Committee on the "Insurable Interests Relating to Trusts" Uniform Act
By David Neufeld
The National Conference of Commissioners on Uniform State Laws (NCCUSL) has appointed a Drafting Committee to propose amendments to the Uniform Trust Code to address the issue of whether life insurance trusts have an insurable interest in the life of the insured person. The scope does not extend to revising what is an insurable interest, but rather to adapt trusts to the existing law.

Would you like to write an article for the eReport?

If you have something to say, and would like your article considered for the eReport, simply email Susan Talley, Editor, at stalley@stonepigman.com for further details.

Charitable Planning Committee
Charitable Planning Committee Comments on Regulations and Other Guidance to be Issued in Response to the Pension Protect Act Provisions Affecting Supporting Organizations.

REAL PROPERTY

Land Use & Zoning Committee
The Land Use & Zoning Committee will presenting the program, "Dark Sky Over America: Light Pollution and Workable Solutions" at the 2008 Spring Symposia.

Mortgage Lending Committee
On March 14, 2008, HUD published for public comment its proposed changes to the Real Estate Settlement Procedures Act. Thanks to Section Fellow Katya Gill of Montgomery, Alabama for this link and materials. Click here for more details.

Young Lawyers

While at the Spring Symposia, join the Young Lawyer Network for fabulous dining and night-life! Let YLN coordinate your "Dine-A-Round" evening at fine or casual dining spots near your hotel. Click here for more information.

Become involved in the substantive work of the RPTE Section by applying for the Fellows Program! Do not miss out. The deadline is June 20th. For more details click here.

Law Students

Don't miss out on your opportunity to be recognized! The June 20th deadline for the Law Student Writing Contest is approaching fast!

New Book from RPTE

How to Build and Manage an Estates Practice, Second Edition
Daniel B. Evans

Specifically tailored to the unique needs of the estates and trusts lawyers, this updated second edition of "How to Build and Manage an Estates Practice" focuses on making your practice better. Written as a "book of ideas," you'll find guidance on marketing, effective client communications fee agreements, and ethics, including the updates to the American Bar Association's Model Rules of Professional Conduct. Whether you are a solo practitioner

or a lawyer at a large firm, you will find the tools you need to make a difference.
More....

FOR OFFLINE READING:
- PDF version - print the whole issue
- PDF of Trust and Estate articles only
- PDF of Real Property articles only

About RPTE eReport

The **RPTE eREPORT** is the bi-monthly electronic publication of the Real Property, Trust and Estate Law Section. It includes practical information for lawyers working in the real property and estate planning fields, together with news on Section activities and upcoming events. **RPTE eREPORT** also provides resources for young lawyers and law students to succeed in the practice of law. For further information on **RPTE eREPORT** or to submit an article for publication, please contact: Susan Talley (Editor) at stalley@stonepigman.com; Cheryl Kelly (Real Property Editor) at CKELLY@thompsoncoburn.com; Robert Steele (Trust and Estate Editor) at steele@whafh.com; or Michael Goler (Managing Editor Emeritus) at Goler@MillerGolerFaeges.com. We welcome your suggestions and submissions.

The materials contained herein represent the opinions of the authors and editors and should not be construed to be those of either the American Bar Association or The Section of Real Property, Trust and Estate Law unless adopted pursuant to the bylaws of the Association. Nothing contained herein is to be considered as the rendering of legal advice for specific cases and readers are responsible for obtaining such advice from their own legal counsel. These materials and any forms and agreements herein are intended for educational and informational purposes only. The authors and other contributors to **RPTE eREPORT** are solely responsible for the content of their submissions, including the accuracy of citations to legal resource materials.

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

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To review our privacy statement, go to http://www.abanet.org/privacy_statement.html.

Section News Technology CLE Groups & Committees Young Lawyers Law Students

Join the Section at its 2008 Spring Symposia

Do not miss the panel presentation on Thursday, May 1, from 10:45 a.m. to 11:45 a.m. entitled "Frying Pans and Fires? Or Prospects Not So Dire?: Hot Topics in Family Limited Partnerships." See the CLE Spotlight below for more details. Also, on Friday, May 2 from 3:30 p.m. to 5:00 p.m., The Income and Transfer Tax Planning Group roundtable discussion will feature US Treasury and IRS officials, Catherine V. Hughes, George Masnik and Karlene Lesho. Important current estate and gift tax issues will be discussed.

On Friday from 1:45 p.m. to 3:15 p.m., a panel presentation of The Synergy Group will discuss the state of the financial markets in "Has the Earth Stopped Shaking? The State of the Commercial Markets Since the Subprime Meltdown". See the CLE Spotlight below for more details.

If you cannot make it to D.C., two CLE programs, "Has the Earth Stopped Shaking? The State of the Commercial Markets Since the Subprime Meltdown" and "Hot Topics in Trusts and Estates" can be accessed as live telecasts. Online registration for the telecasts is available at http://www.abanet.org/cle/home.html.

Cannot Attend the Spring Symposia?
Join RPTE for Great Benefits!

The Benefits of Membership include:

- A complimentary subscription to *Probate & Property* magazine, the *RPTE eReport* and the *Real Property, Trust and Estate Law Journal*.
- Discounts on monthly cutting edge eCLE programs.
- Access to CLE meeting materials, practice aids and more on the RPTE website.

For more information on the benefits of RPTE membership, visit **www.abanet.org/rpte**.

Online Collaboration Tools: Smarter Ways to Work Together

Tom Mighell

Collaboration has always been a necessary aspect of a lawyer's practice. Every day, lawyers must work with clients, colleagues and even opposing counsel as a matter of course. In the past, the telephone, fax machine and face-to-face meetings were the primary ways in which lawyers worked with others.

With the rise of the Internet as a communication tool, lawyers now have a number of new and intriguing methods to collaborate with others and become more productive in the process. This column will discuss a few of the latest tools lawyers can use to work smarter, not harder -- together.

Working on Documents Online. When a lawyer wants to work on a document with other professionals, many will attach a document to an e-mail, send it to multiple people, and await the edits. Several online document sites make it easy for a group to work on the same document at the same time. For example, Google Docs (http://docs.google.com) allows the creation and sharing of simple documents, spreadsheets, and even presentations, so others can view or edit them online. When everyone finishes with the document, it can be saved as a Word or PDF file. For security reasons, the user might not want to keep these documents online for long periods of time, but services like Google Docs are terrific ways to work on documents with others.

Simple Screen Sharing. Sometimes a lawyer might need to work on a document or other file with another person, but in real time. In this scenario, using a screen-sharing program for an online meeting might be useful. My favorite free option is CrossLoop (http://www.crossloop.com), but it can only be used by two people at a time. Each user must install the program on his or her computer; then one person requests access to the other's screen. After access is granted, the user can see everything that happens on that person's computer -- documents, drawings, images, etc. -- and can even control that person's computer. A more advanced (but not free) screen-sharing program is Adobe Connect (http://www.adobe.com/products/connect), which allows larger groups to participate in an online meeting or presentation.

Project Management. A number of project management sites have appeared on the Internet that makes it simple to manage teams on cases, transactions or other projects. One such tool is Basecamp (http://www.basecamphq.com), which provides various levels of service and online storage for between $12 and $149 a month. Basecamp's features include file storage, message boards, to-do lists, and other collaboration tools. Many solo and small firm lawyers have started to use Basecamp as a client "extranet" where clients can have their own dedicated Basecamp page to view case files, ask questions, or keep track of deadlines. This is a great way to work with clients online at a relatively low cost.

Wikis. A wiki is, simply, a Web page that can be easily edited by anyone. The most famous example is Wikipedia (http://www.wikipedia.org), the encyclopedia that anyone can edit. Wikis have tremendous potential for lawyers who want to collaborate with their clients and others. For example, a lawyer can create a wiki for trial strategy and preparation, an online manual of employee policies and procedures, or a simple directory of resources in a particular subject area. To learn more about wikis and whether this resource might be right for you, visit WikiMatrix (http://www.wikimatrix.org), a site that assists in determining which wiki best suits your needs.

File Sharing. It seems that the electronic files we use in our daily work keep getting bigger and bigger. Whether they are PDF e-briefs or transaction documents, the size of these files is often more than our mail servers can handle. A number of sites now make it much easier to send large files to others. One of the oldest, best-known sites is YouSendIt (http://www.yousendit.com), which allows users to send a document up to 100MB for free. Simply upload a file to the YouSendIt site, and an e-mail with a download link to the file is sent to the recipient. YouSendIt also offers subscription plans if you want to send larger files. Another current favorite of mine is drop.io (http://drop.io). With this resource, you can create an online "exchange" site to "drop" multiple files (up to 100MB). Then simply send the URL of the site to the recipients, and they can download the files at their leisure (the site can stay "live" for up to one year).

These Web resources all have one thing in common: They can help lawyers use the Internet to collaborate with anybody, no matter where in the world they happen to be. You owe it to your practice to implement one or more of these tools in the way you work. They can help you be more productive and efficient, which your clients will certainly appreciate.

Restaurant Options

Penang - DC 1837 M Street, NW Washington, DC 20036 (202) 822-8773
Part of a New York-based chain, Penang, which spreads across three rooms and two levels, is elegant and trendy. Guests wearing casual attire or suits can be seen in the bar lounging on cool couches and hovering over low tables. The cuisine is excellent and the atmosphere is lively.
Dining Style: Casual Elegant, Asian, Indonesian / Malaysian
Price: $30 and under
Neighborhood: DC - Dupont Circle

Grillfish DC 1200 New Hampshire Ave, Washington, DC (202) 331-7310
Grillfish is a casual, moderately-priced restaurant, specializing in fresh, grilled seafood and deliciously-sauced pasta. The restaurant is dominated by its "signature" oversized, floor-to-ceiling, erotic mural extending the entire wall behind the large stone bar – a definite conversation piece! The bar is ornately decorated with massive mirrors, large columns and a multitude of glowing candles. The unique decor along with the open kitchen where flames leap from the grill, create a warmth and intimacy in a casual atmosphere.
Dining Style: Casual
Price: Under $30
Cross Street: M Street

M Street Bar & Grill
2033 M Street NW Washington, DC 20036 (202) 530-3621
Attached to the luxurious St. Gregory Hotel, the M Street Bar & Grill provides an urban stylish dining atmosphere. The look and feel is contemporary with original art and blond wood walls, as well as two fireplaces to set the tone. M Street Bar & Grill is well known for its eclectic, innovative menu and the food is always center stage. Creatively presented, Chef Ronde Murphy focuses on the rich taste of the freshest ingredients and draws inspiration form southern cuisine with occasional flights of fancy into Mediterranean, Asian or Mexican cuisine.
Dining Style: Contemporary American, Fusion / Eclectic
Price: $30 and under
Cross Street: 21st Street

Vidalia
1990 M Street Washington, DC 20036 (202) 659-1990
Chef/owner Jeffrey Buben's Vidalia features an expanded bar with 30 wines by the glass.
Vidalia's cuisine is regional American cuisine with a subtle southern influence. Favorites of Vidalia regulars include the delicate crab cakes of almost pure lump crabmeat, the famous shrimp and grits, and our popular renditions of veal sweetbreads.
Dining Style: Fine Southern Dining
Price: $31 to $50
Cross Street: 20 Street NW

MEMORANDUM

To: ABA Leadership

From: Dennis M. Horn,
ABA Advisor for NCCUSL Uniform Law Project

Dated: December 4, 2007

Re: Real Estate Transfer on Death Deeds

What is a Transfer on Death Deed:

Probate is an expensive process, both in the court resources used and in expenses to the litigants. Under the leadership of the ABA and the National Conference of Commissioners on Uniform State Laws (NCCUSL), states have promulgated laws authorizing will substitutes for the transfer of property at death without probate. Examples of assets that today routinely pass outside of probate include the proceeds of life insurance policies and pension plans, securities registered in transfer-on-death (TOD) form, and funds held in pay-on-death (POD) bank accounts.

A new device, the Transfer on Death deed (TOD deed), is designed to transfer real property upon the death of the owner without encumbering the real property during the owner's life and without probate. By executing and recording a TOD deed, an owner may designate a beneficiary or beneficiaries to receive the property at the owner's death without waiting for probate and without the beneficiary designation needing to comply with the witnessing requirements of wills. By these deeds, the owner identifies the beneficiary or beneficiaries who will succeed to the property at the owner's death. During the owner's lifetime, the beneficiaries have no interest in the property, and the owner retains full power to transfer or encumber the property or to revoke the TOD deed.

NCCUSL Timetable:

Ten states currently authorize TOD deeds. In the chronological order of the statutes' enactment, the states are: Missouri (1989), Kansas (1997), Ohio (2000), New Mexico (2001), Arizona (2002), Nevada (2003), Colorado (2004), Arkansas (2005), Wisconsin (2006), and Montana (2007). Some other states, including California and Minnesota, are studying the issue. In 2006, NCCUSL agreed to draft a uniform law to implement TOD deeds and appointed a Drafting Committee. The aim of our Drafting Committee is to produce a Uniform Real Property Transfer on Death Act for states to consider for enactment. The Drafting Committee has met twice and has developed a working draft of the law, which is available for review and comment on NCCUSL's website. The current plan is to complete the drafting process within two years, hence to submit the uniform law to NCCUSL for approval in Summer 2009 and to the ABA in the year following adoption by NCCUSL.

Information and Feedback:

At the request of the ABA, the ABA Real Property and Trust Section has appointed both an ABA Section Advisor and an ABA Advisor to the Committee. As the ABA Advisor, I am tasked with disseminating information about the draft law within the ABA and obtaining feedback.

Information about the Committee's work and the full text of drafts and memoranda circulated to the Committee can be found on NCCUSL's website at www.nccusl.org/Update/CommitteeSearchResults.aspx?committee=278

Comments and suggestions on this project in progress are welcome. Please direct your comments either to me, as the ABA Advisor, at Dennis.Horn@hklaw.com or to the Reporter, Thomas P. Gallanis, Professor of Law, University of Minnesota, at gallanis@umn.edu

NEW CHANGES TO IRC RULES ON VACATION-SECOND HOMES AND 1031 EXCHANGES

By Stephen Wayner, Esq., CES
First Vice President
Bayview 1031

Many tax practitioners represent clients who own vacation-second homes. These dwellings take on a variety of personas -- a beautiful home in the country, a cozy cottage on a lake, a gorgeous condominium on the ocean, or a rustic cabin in the mountains.

The exclusion of gain under Internal Revenue Code ("IRC") Section 121 does not apply to second homes because the principal residence requirements are not met. As a result, clients are not left with many options to defer taxes when they dispose of their vacation-second home assets.

However, there is one major tax strategy that comes to the rescue: a Section 1031 tax-deferred exchange.

The cloudy area for tax practitioners was how to ensure that vacation-second homes qualified under Section 1031. Recently, the IRS ("the Service") created a new formula – Rev. Proc. 2008-16. Under this formula, the dwelling unit will qualify as a "like kind property" under Section 1031. The new procedure[1] assures that the Service will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment in order to be eligible for safe harbor protection under IRC Section 1031.

In a recent conversation with J. Peter Baumgarten of the Office of Associate Chief Counsel (Income Tax & Accounting) of the Service and the author of Rev. Proc. 2008-16, we discussed many of the issues presented herein. We agreed that, as a result of the Rev. Proc., tax practitioners now have a standard that is easily identifiable for determining whether a client's dwelling unit (vacation home/second home) should qualify as an investment or property held for productive use in a trade or business under Section 1031.

For background purposes, IRC Section 1031 is known as the "Tax Deferred Exchange" provision. It provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of "like kind" that is to be held either for productive use in a trade or business or for investment (replacement property).[2]

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[1] Rev. Proc. 2008-16

[2] IRC Section 1031(a)

As far back as 1959, the Service concluded that gain or loss from an exchange of personal residences may not be deferred under Section 1031 because personal residences are not property held for productive use in a trade or business or for investment.[3]

In *Moore v. Commissioner*,[4] the taxpayers sold one home on a lake and tried to exchange that for another home on the same lake. Neither of these homes was ever rented or ever offered for rent. Expenses were never deducted under Section 212 for business or investment expenses. Instead, interest was deducted under Section 163 as personal home mortgage interest rather than as investment interest, and both homes were used exclusively by the taxpayers for their own personal use. The taxpayers stated that because they expected the homes to appreciate in value, the homes should then qualify under Section 1031 for a tax deferred exchange. The Tax Court disagreed and held that taxpayers with the "…mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence."[5]

So, if the taxpayers could not qualify for Section 1031 tax deferral treatment because they were the only users of the property, the next issue for consideration was whether vacation homes minimally used by taxpayers could qualify under Section 1031 for tax deferral treatment. Moreover, what if the vacation/second home property was only rented out for a short period of time each year? Could that property meet the criteria of an investment and thereby qualify for Section 1031 tax deferral treatment?

Historically, Section 280A covered the issues of allowing deductions on dwelling units that taxpayers use as residences, which included vacation and second homes. This section states that a taxpayer who personally uses the dwelling unit the greater of 14 days a year or 10% of the number of days during the year for which the dwelling unit is rented at fair market value, is using the property as a "residence" and not as an "investment".[6] "Personal use" under this section of the IRC not only includes use by the taxpayer but also includes: use by any member of the taxpayer's family, or anyone who is a co-owner; use by any person utilizing the dwelling unit under an agreement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or rental of the unit by an individual for less than fair market value.[7]

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3 Rev. Rul. 59-229, 1959-2 C.B. 180

4 *Moore v. Commissioner*, T.C.Memo. 2007-134

5 *Id.*

6 IRC Section 280A(d)

7 *Tax Free Exchanges Under Section 1031(2007),* Long and Foster, Thomson/West, Pages 2-37

Most would agree with one tax analyst, who suggested it would be unwise for a taxpayer to deduct mortgage interest on a vacation home as a second home and then take the position that the property was held for investment under Section 1031. Knowing that many taxpayers hold dwelling units primarily for production of rental income, but at the same time occasionally use the property for their own personal use, the Service recently produced Rev. Proc. 2008-16 to clarify some of these issues.

Under Rev. Proc. 2008-16, the Service will not challenge whether a dwelling unit ("real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities"[8]) qualifies under Section 1031 as property held for investment or held for productive use in a trade or business, if the qualifying use meets the following standards:

(1) For the relinquished property:

- (a) the dwelling unit must be owned by the taxpayer for at least 24 months immediately before the exchange (defined as the "qualifying use period"[9]); and
- (b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange:
  - (i) The taxpayer must rent, at fair rent, for at least 14 days or more the dwelling unit to another person or persons, and
  - (ii) The taxpayer may not personally use the dwelling unit the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit was rented to another at a fair rental rate.[10]

(2) Similarly, for the replacement property:

- (a) The dwelling unit must be owned by the taxpayer for 24 months or more immediately after the exchange (the "qualifying use period"); and
- (b) Within the qualifying use period, in each of the two 12-month periods immediately after the exchange:
  - (i) The taxpayer must rent, at fair rent, to another person or persons for at least 14 days or more, and
  - (ii) The taxpayer may not personally use the dwelling unit the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit was rented to another at a fair rental rate.[11]

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8 Rev. Proc. 2008-16, Section 3.02

9 Rev. Proc. 2008-16, Section 4.02 (1)(a)

10 Rev. Proc. 2008-16, Section 4.02 (1)(b)

11 Rev. Proc. 2008-16, Section 4.02 (2)(b)

The Service defines "personal use of a dwelling unit" as occurring on any day that the taxpayer is deemed to have used the dwelling unit for personal purposes under Section 280A(d)(2), taking into account Section 280A(d)(3), but not Section 280A(d)(4)[12].

What is a "fair rental"? Normally a real estate practitioner would describe that term as fair market rent, but the Service uses the term "fair rental" and determines it to be based upon all of the "facts and circumstances" that exist when the rental agreement was entered into between the parties. The Service will also look at all of the rights and obligations of the parties to the rental agreement.[13]

What happens if the taxpayer files his or her federal income tax return and reports the transaction as a Section 1031 exchange, believing that the dwelling unit used as a replacement property will meet the appropriate qualifying standards, and then it is determined that this replacement property does not meet the necessary qualifying standards? The Service suggests that the taxpayer file an amended return and not report the transaction as an exchange under Section 1031.[14]

Rev. Proc. 2008-16 is limited in that it only determines whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031.[15] It does not give safe harbor protection for all of the other requirements for a "like kind" exchange under Section 1031 or under the Section 1031 regulations.[16] The effective date of Rev. Proc. 2008-16 is March 10, 2006.[17]

What happens if the taxpayer's dwelling unit does not qualify under Rev. Proc. 2008-16 for safe harbor protection? The taxpayer may still try to qualify for Section 1031 treatment, but it will have to overcome the requirements set forth in Rev. Proc 2008-16.

Following are examples that illustrate how this new Rev. Proc. works. In the first example, Taxpayer Tessie has a "second home" that she has rented out for the past five years to the same renter for the entire summer. Tessie uses the property for 10 days a year during Thanksgiving and Christmas vacations. Tessie reports the income from the rental on her income tax return and now wants to sell the property and use Section 1031 to purchase a small shopping center in her home town. Tessie's "dwelling unit" (second home) will qualify for tax deferral treatment under Section 1031 because she rented the dwelling unit for more than 14 days a year,[18] she never personally used

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[12] Rev. Proc. 2008-16, Section 4.03

[13] Rev. Proc. 2008-16, Section 4.04

[14] Rev. Proc. 2008-16, Section 4.05

[15] Rev. Proc. 2008-16, Section 4

[16] *Id.*

[17] Rev. Proc. 2008-16, Section 5

[18] Rev. Proc. 2008-16 Section 4.02(1)(a)

the dwelling unit for more than 14 days in any one year,[19] and finally she exchanged the dwelling unit for real estate that qualifies as "like kind"[20] property.

In the second example, Taxpayer Tim has owned a mountain cabin on a lake for 20 years. Every year, Tim spent the summer fishing on the property. About five years ago he rented, at below fair rent, the dwelling unit to a fishing buddy of his for one week. He never reported the income and never tried to rent the dwelling to anyone else during the entire 20-year period he owned the cabin. Tim is now selling the cabin (dwelling unit) and wants to buy another cabin, higher on up the mountain.

According to Rev. Proc 2008-16, Tim's mountain cabin will not qualify as a dwelling unit (relinquished property) for Section 1031 purposes, because he did not have it rented at a fair rental for at least 14 days in each of the preceding 2 years prior to the transfer;[21] and he used it for more than 14 days a year or 10% of the number of days that he had the dwelling unit rented.[22] Another important problem is that Tim did not rent the unit to his friend at fair market.[23] The property Tim wants to purchase will probably not qualify as "like kind" because there is no intent to use it as an investment property or property used in a trade or business.[24]

Rev. Proc. 2008-16 would seem to clear the air on many of the foggy issues surrounding Section 1031 exchanges for vacation and second homes. That said, the taxpayer must still satisfy any and all of the other requirements for a like-kind exchange in order to qualify for tax deferred treatment.[25]

Stephen A. Wayner, Esq., C.E.S., brings over 35 years of legal and real estate experience to his position as First Vice President of Bayview 1031. Bayview 1031, a Qualified Intermediary for 1031 Tax Deferred Exchanges of Real and Personal Property, is a subsidiary of Florida-based Bayview Financial L.P., a multi-billion asset financial and real estate services company. For more information, call 866-903-1031 or visit www.bayview1031.com

[19] Rev. Proc. 2008-16 Section 4.02(1)(b)

[20] 1031(a)

[21] Rev. Proc. 2008-16 Section 4.02(1)(b)(i)

[22] Rev. Proc. 2008-16 Section 4.02(1)(b)(ii)

[23] Rev. Proc. 2008-16 Section 4.04

[24] Section 1031(a)

[25] Rev. Proc. 2008-16, Section 4.06

Mirowski v. Commissioner

T.C. Memo. 2008-74; Court Rejects IRS's §§2036(a)(1), 2036(a)(2), 2038, and 2035 Arguments

April 2008

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Synopsis

Decedent (Mrs. Mirowski) signed LLC documents (naming herself as the sole general manager) on August 27, 2001. On 9/01/2001, the decedent transferred 51.09% of the rights under a valuable patents license agreement (that generated revenues of millions of dollars per year) in return for 100% of the member interests of the LLC in which she was named the sole general manager. From 9/5/2001 to 9/7/2001 she transferred marketable securities worth about $62 million to the LLC. On 9/7/2001, the decedent made gifts of a 16% interest in the LLC to each of her three daughters' trusts, retaining the other 52% interest. The decedent retained $7.5 million of personal assets (including $3.3 million of cash and cash equivalents) outside the LLC. The decedent retained assets to pay her living expenses and all obligations except gift taxes on the 48% gift that she intended to make when the LLC was created, but the court concluded that she had the ability to pay the gift taxes (with her retained cash, with loan proceeds from amounts that she could borrow, and from distributions from the LLC attributable to royalties that the LLC would receive).

The decedent died unexpectedly on 9/11/2001, first experiencing a significant deterioration in her condition on 9/10. Thus, during the 16 days before the decedent died, the LLC was formed, contributions were made to it, and the decedent made gifts of 48% of the member interests.

After the decedent's death, the partnership distributed $36.4 million to her estate to cover gift and estate taxes, legal fees and other estate obligations. (Following the decedent's death, the three daughters owned the LLC in equal shares, and they opted not to make pro rata distributions to themselves.)

The IRS argued that the assets in the partnership (including the assets attributable to the 48% interest that was given to the daughters' trusts) should be included in the decedent's estate under §§2036(a)(1), 2036(a)(2), 2038, and 2035(a). The decedent retained assets for living expenses, but the IRS argued that §§2036(a)(1) and (a)(2) and 2038 applied to the contribution of assets to the LLC, and to the 48% gifts of the LLC interests, and that §2035(a) applied to all of the transfers. The court rejected all of those arguments.

As to the original transfers to fund the LLC, the court determined that the bona fide sale for full consideration applied. As to the assets attributable to the 48% gifts of LLC interests, the court emphasized that the decedent's death was unexpected and that there was no understanding that the LLC assets would be used to pay gift taxes, and the estate taxes were not discussed or anticipated because no one expected the decedent to die any time soon after the transfers. The court did not apply §2036(a)(2) or 2038 even though the decedent was the sole general manager of the LLC at her death. Section 2035 did not apply because neither 2036 nor 2038 applied, so she never relinquished rights that would have otherwise triggered inclusion under §§2036 or 2038.

Key Facts

The result of the case is very fact dependent, and the facts are summarized below in some detail.

(1) The decedent's husband died in 1990, leaving all of his estate to decedent (except $600,000 passing to a bypass trust). The estate included an approximately 73% interest in valuable patent licenses for a medical device that he had invented.

(2) In 1992, the decedent gave 21.78% of the patent license rights equally to trusts for her three daughters, retaining 51.09%.

(3) In 1999-2000, the decedent expressed the desire to provide for her three daughters and grandchildren on an equal basis, and for the daughters to have a close working relationship.

(4) In May 2000, the decedent was first introduced to the concept of an LLC, and documents were sent to her in August, 2000.

(5) In January 2001, the decedent wore a blister on her foot during a trip to France; she developed a foot ulcer as result of the blister and her diabetes.

(6) In March 2001, the decedent had a surgical procedure for the foot ulcer and had various treatments for the foot ulcer between March and August 2001. The doctors discussed various alternatives, including amputation, but the decedent was not comfortable with amputation.

(7) In March and July of 2001, the decedent purchased interests in several retirement communities (suggesting that that she did think that her death was imminent).

(8) In August 2001, there was a family meeting of the daughters where they discussed the LLC and the decedent's intent to make gifts of LLC interests.

(9) <u>Legitimate and Significant Non-Tax Purposes</u>. Based apparently on the testimony of two of the three daughters, the court found that the decedent was aware that "certain tax benefits" could result from the LLC, but they were not "the most significant factor" in the decision to form the LLC. The court found that the decedent had the following legitimate and significant purposes:

> "(1) Joint management of the family's assets by her daughters and eventually her grandchildren; (2) maintenance of the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of her daughters or to each of her daughters' trusts; and (3) providing for each of her daughters and eventually each of her grandchildren on an equal basis."

(10) A "legitimate, but <u>not</u> significant, nontax reason" was to provide additional protection from potential creditors, including particularly divorce protection for her daughters.

(11) On August 27, 2001, the decedent signed the LLC documents. The decedent was the sole general manager from the time the LLC was created until the time of her death (16 days later).

(12) On September 1, 2001, the decedent transferred the patents and her 51.09% interest in the patents license agreement to the LLC in return for 100% of the member interests. (No person other than the decedent made any transfers of property to the LLC.) (The patents license rights were valuable, producing royalties of millions of dollars per year.)

(13) On September 5-7, 2001, the decedent transferred more assets to the LLC, including about $62 million of marketable securities and cash.

(14) Even after the various transfers to the LLC, the decedent retained about $7.5 million of personal property assets, including $3.3 million of cash or cash equivalents. The court found that the decedent "retained more than enough personal assets to meet her living expenses" but did not retain enough to pay anticipated gift taxes attributable to the contemplated gifts of LLC interests.

(15) From the outset, the decedent contemplated making gifts of interests in the LLC after creating it. On September 7, 2001, the decedent gave a 16% interest to each of her three daughters' trusts. The decedent retained the remaining 52% interest in the LLC.

(16) The daughters did not know how the decedent planned to pay the substantial gift taxes (eventually determined to be over $10 million), but she had retained substantial personal assets, including over $3 million in cash and cash equivalents. In addition, the decedent "anticipated receiving as an interest holder in [the LLC] future income of millions of dollars a year attributable to royalty payments" from the license rights that were contributed to the LLC. Also, the

daughters believed that the decedent could have borrowed against her retained personal assets and her retained 52% interest in the LLC in order to pay the gift tax liability. "At no time before Ms. Mirowski's death did the members of [the LLC] have any express or unwritten agreement or understanding to distribute assets of [the LLC] in order to pay that gift tax liability." There were similarly no discussions about how estate taxes would be paid because at no time before September 10, 2001 did the doctors, the decedent or her family expect her to die.

(17) Despite the finding immediately above that the decedent "anticipated receiving as an interest holder in [the LLC] future income of millions of dollars", the court found that there was no express or unwritten agreement or understanding among members of the LLC that the decedent, at her own discretion, could have access to assets she had transferred to [the LLC], the right to income from those assets, or the right to determine who can possess or enjoy those assets.

(18) The decedent was admitted to the hospital for more treatments on her foot ulcer beginning on August 31, 2001. However, until September 10, everyone thought that the treatments would allow her to recover and return home. The decedent discussed with a daughter who lived in Philadelphia that she planned to travel to her home on September 18 for a Rosh Hashanah celebration. Another daughter left the country to attend a medical conference on September 6.

(19) The decedent's medical condition deteriorated significantly on September 10. The doctors recommended amputation to avoid further complications including possible life-threatening infections. The decedent refused, and she developed "sepsis, caused by an overwhelming infection of the blood stream". The decedent died the next day, September 11, 2001 [yes, *that* September 11].

(20) In 2002, $36.4 million was distributed from the LLC to pay transfer taxes, legal fees, and other estate obligations. (The decedent's will left her 52% interests in the LLC equally to her daughters' trusts, so they would own 100% of the LLC interests. The daughters decided not to make pro rata distributions to themselves. "In making that decision, [the daughters] had in mind that those members will own collectively 100% of [the LLC], in three equal shares, after decedent's estate is closed.")

(21) The estate filed a gift tax return reporting $9.7 million of gift tax. Eventually, the gift tax was settled, increasing the value of each 16% interest from $5.7 million to $6.8 million (see footnote 36).

(22) The estate filed an estate tax return reporting estate taxes of $14.1 million. The IRS proposed to increase the gross estate from $27.8 million to $71.1 million and increase the estate tax by $14.2 million.

(23) After the decedent's death, the three daughters carried out the decedent's intentions for them to actively work together in managing the LLC assets, making joint investment decisions, and managing the patents licenses and related litigation. The LLC has invested in certain investments that would not have been available on an individual basis to the daughters or their trusts if the decedent had transferred her assets to them separately rather than transferring the assets to the LLC for investment as a single pool.

Holding

Sections 2036(a)(1), 2036(a)(2), and 2038 do not apply to the contribution of assets to the LLC or to the LLC assets attributable to the 48% member interests that were given to the daughters' trusts. Section 2035 does not apply, in light of the fact that the decedent did not relinquish any rights or powers that would otherwise have triggered inclusion under §§2036 or 2038.

Analysis

(1) Burden of Proof. Neither party addressed §7491(a), and the court concluded that the resolution of the issues does not depend on who has the burden of proof.

(2) Application of §2036 and §2038 to Contributions From Decedent to LLC.

a. Bona Fide Sale For Full Consideration Exception.

1. Legitimate and Significant Nontax Reasons. While the decedent was aware of potential tax advantages, they were not the "most significant factor" in the decision to create the LLC. The court cited the "legitimate and significant nontax reason" test from Bongard, and found that the decedent had three legitimate and significant nontax reasons.

- Joint management. The decedent wanted her daughters and eventually her grandchildren to jointly manage the family assets, based on her family background of working together in a family business.
- Single pool of assets. The decedent wanted to maintain her assets in a single pool for her daughters to allow for investment opportunities that would otherwise be unavailable. Indeed, certain investment opportunities at Goldman Sachs would not have been available if the assets had been separated among the daughters and their trusts.
- Equal provisions. The LLC assisted with the decedent's goal of providing equally for her daughters, and eventually her grandchildren.

[Observe that these are pretty common goals. These same reasons potentially could apply in many family situations.]

Creditor planning. Creditor planning was an additional "legitimate but not significant" nontax reason, particularly providing possible divorce protection for the daughters.

2. Credibility of Witnesses. Apparently, the nontax reasons were established by the testimony of two of the daughters. No documentary evidence of these reasons were mentioned in the opinion. The IRS argued that their testimony should be disregarded, because of their personal interest. However, the court found the witnesses to be credible, based on their "candor, sincerity, and demeanor" as well as the "reasonableness" of their testimonies. The court found them to be "completely candid, sincere, and credible".

3. IRS Counter Arguments As to Bona Fide Test. The IRS restated some of the standard reasons that have been cited in prior cases.

- Failure to retain assets for anticipated financial obligations. The court found that the only anticipated significant financial obligation when the decedent formed and funded the LLC was a substantial gift tax that would be attributable to the contemplated gifts of member interests. However, there was no express or unwritten agreement or understanding to distribute LLC assets to pay the gift tax liability. The decedent could have (i) used a portion of her remaining $7.5 million of personal assets that she retained, including cash and cash equivalents of over $3.3 million, (ii) used a portion of the distributions "that she expected to receive as a 52% interest holder in [the LLC] of the

millions of dollars of royalty payments… that she expected {the LLC] to receive", and (iii) borrowed against her personal assets that she retained and her 52% interest in the LLC.

As to estate tax payments, the court observed that at no time before September 10, 2001 did the decedent, her daughters, or her physicians expect her to die. Consequently, "at no time did Ms. Mirowski and her daughters discuss or anticipate the estate tax and similar transfer taxes and the other estate obligations that would arise only as a result of Ms. Mirowski's death".

- Lack valid functioning business operation. The court concluded that the LLC has at all times been a valid functioning "investment operation and has been managing the business matters related to the …patents." Moreover, the court rejected the suggestion that the activities of the LLC "had to rise to the level of a 'business' under the Federal income tax laws in order for the exception under section 2036(a) …to apply."
- Delay in forming and funding the LLC until shortly before death. The court responded by noting that the decedent was not expected to die before her health quickly and unexpectedly deteriorated on September 10.
- "Sat on both sides." The IRS repeated the statement, that has been included in various cases (but has never appeared to be a determinative factor, but just one of many listed by a court in what the court perceives as an abusive situation), that the decedent "sat on both sides" of the transaction (apparently meaning that there was no negotiation). The court responded that would eliminate single member LLCs from the statutory exception. Furthermore, the court noted that only the decedent contributed assets to the LLC, apparently intimating that it is totally expected that only the sole contributing member of the entity would make decisions about its terms.
- Post-death distributions. The IRS argued that the post-death distribution of $36.4 million keeps the transfer to the LLC from meeting the bona fide sale exception. The court responded that her death was not expected, so the decedent and the daughters never discussed or anticipated providing for the estate taxes and estate obligations. Perhaps more important, the court seems to suggest that failing to keep enough assets to pay estate taxes does not necessarily negate the applicability of the exception:

> "Moreover, we reject the suggestion … that respondent's contention … is determinative in the instant case of whether Ms. Mirowski's transfers to [the LLC] were bona fide sales for adequate and full consideration in money or money's worth under section 2036(a)."

4. Full Consideration Requirement. The court finds that the Bongard standard is satisfied: (i) The decedent received interests proportionate to her transfers (i.e. 100% in this case); (ii) her capital account was credited with her transfers; and (iii) on liquidation or dissolution she had the right to receive property in accordance with her capital account.

5. IRS Counter to Full Consideration Requirement. The IRS's countering argument is a twist on its "gift on creation" and its "integrated transaction" theories. The IRS argued that because the decedent always intended to make gifts of 48% of the LLC interests, she did not receive full consideration for her transfers to the LLC. The IRS does not use the phrase "integrated transaction," but that is the effect. The court disagreed, treating (i) the transfers to the LLC in return for 100% of the member interests, and (ii) the subsequent gifts of member interests as separate transactions. The full consideration requirement is satisfied as to the contribution to the LLC if proportionate interests are received in the first step.

b. Section 2036(a)(1) and (a)(2) and §2038 Retained Interests and Powers. The court said that it did not have to address whether there were retained interests under §§2036(a)(1) or (a)(2) or 2038 as to the transfers to the LLC because the bona fide sale exception applied. (The §§2036 and 2038 issues are discussed more fully below as to the transfer of the 48% member interests, because the bona fide sale exception does not apply to those transfers.)

(3) Application of §§2036 and 2038 to Transfer of 48% Interests by Gifts. The court separately analyzed the application of §§2036 and 2038 to the subsequent gifts of LLC interests. (All too often, courts have addressed whether to include all FLP or LLC assets in the estate under §2036, even as to assets attributable to gifts of FLP or LLC interests, without addressing how the string statutes would apply to the gifts. Even if §§2036, 2038, or 2035 apply, one possible approach would be to bring back just the transferred interest into the estate — i.e. the discounted LLC interest in this situation. The court does not address that approach. However, its rebuttal to the IRS's lack of full consideration argument clearly recognized the initial gift and subsequent gift as separate transactions.)

a. Bona Fide Sale Exception Not Applicable. The court easily concludes that the bona fide sale for full consideration exception does not apply, because these transfers are gifts, and obviously were not made for full consideration.

b. Section 2036(a)(1), Express Agreement. The IRS apparently argued that the decedent had the right under the operating agreement to cause the distribution to herself of all income and assets of the LLC, even including income and assets attributable to the 48% interests that were given to the trusts. The IRS says there is an express agreement that the decedent would continue to retain the possession or the enjoyment of or the right to income attributable to the 48% member interests that were given to the daughters' trusts because the decedent was the general manager, and the general manager had sole authority to manage the LLC affairs, including the authority to determine the timing and amounts of distributions. The LLC operating agreement says that except as otherwise provided, "the timing and the amount of all distributions shall be determined by the Members holding a majority of the Percentages then outstanding".

The court responds that the general manager has a fiduciary duty under state law. Also, other provisions of the operating agreement require pro rata allocations of profit and loss and pro rata distribution of capital proceeds from capital transactions. Furthermore, the authority to determine the timing and amounts of all distributions was a power given to the majority members, not the general partner.

Even as to the decedent's authority as the majority holder of the member interests, the section referring to determining the timing and amounts of distributions is subject to other provisions of the operating agreement, including pro rata distribution of "cash flow", pro

rata allocation of profit and loss and pro rata distribution of capital proceeds from capital transactions.

c. Section 2036(a)(1), Implied Agreement. The IRS argues there was an implied agreement of retained possession or enjoyment or income attributable to the 48% interests that were given to the daughters' trusts because of the post mortem distribution of $36 million to the estate in order to pay transfer taxes, legal fees and estate obligations. The court responded that the decedent's death was not anticipated at the time of the transfers, and there was no understanding to make LLC distributions to pay the gifts taxes or other amounts due after her death.

The court did not specifically address what suggested an implied agreement that the decedent somehow kept the right to receive assets attributable to the daughters' interests, when her own 52% interest was sufficient to fund the $36 million of distributions.

The $36 million was paid as a "distribution" from the LLC, and was not accomplished by purchasing assets from the decedent's estate or redeeming some of the estate interests (as was done in the Erickson case.) Even so, the court disagreed that the post-mortem $36 million distribution evidenced an implied agreement of retained enjoyment of assets attributable to the 48% interest that had been given to the daughters' trusts. The court acknowledged that there were not pro rata distributions to the other members, but noted that was a decision by the daughters in light of the fact that their trusts would equally own 100% of the member interests in the LLC after the decedent's estate was settled.

d. Section 2036(a)(2). The IRS argued that the decedent kept the right to designate who could possess or enjoy the transferred property or the income therefrom as to the 48% interests that were given to the daughters' trusts. The IRS points to the decedent's right to dispose of assets in the ordinary course of business (with the approval of the daughters), and the decedent's power as majority member owner to determine the timing of the distribution of capital transaction proceeds. *[Observe: The IRS does not argue that merely being the sole general manager of an LLC results in keeping proscribed powers under §2036(a)(2).]* The court said that it rejects that argument for the same reasons it gave for the similar argument as to the express retention of a §2036(a)(1) right under the same general reasoning.

e. Section 2038. The issue is whether the enjoyment of the transferred property (i.e., the gifts of the 48% interests) was subject to a power exercisable by the decedent alone or in conjunction with another person to alter, amend, revoke, or terminate within the meaning of §2038(a)(1). The IRS gave the same reasons as under its §2036(a)(2) argument, and the court summarily rejects the arguments for the same reasons as under the §2036(a)(2) analysis.

(4) Section 2035. Because §§2036 and 2038 do not apply as to any of the transfers, §2035(a) cannot apply, because it only applies to the relinquishment of powers that would otherwise cause inclusion under those sections (or §§2037 or 2042, neither of which are applicable).

Observations

(1) Smell Test. The only way to rationalize the various FLP/LLC §2036 cases is to recognize that the courts apply a "smell test" to avoid allowing a valuation discount in what the court perceives as abusive case involving paper shuffling (often immediately before death) just to generate a valuation discount. The estate in Mirowski passed the smell test — Judge Chiechi perceived that

the family did not create the LLC just to get a valuation discount, but she believed the testimony of the daughters that there were significant non-tax reasons for creating the LLC, even though those reasons related primarily to how the assets would be managed after they were transferred to trusts for her daughters.

(2) Transfer Shortly Before Death. Most of the FLP and LLC §2036 cases have involved the creation of FLPs/LLCs shortly before the decedent's death. This case continues that pattern, with the entire formation, funding, and gifting occurring within only 16 days of the decedent's death. That appears to be a common theme of situations that the IRS chooses to take to court. However, in this case the court found strong evidence that the decedent's death was not anticipated when the LLC was formed and funded or when the gifts were made.

(3) Significance of Tax Advantages Not Being "The Most Significant Factor." The court found that the tax advantages were not "the most significant factor" in the decision to form and fund the LLC. Is that vital? What if there were "legitimate and significant nontax reasons, but tax savings was the "most significant factor"? Would that mean that the exception could not apply? Thus far, no court has specifically imposed that requirement.

Perhaps this principle is being applied by the courts but in a non-explicit manner. Generally speaking, the same reasons that are recognized as "legitimate and significant nontax reasons" in this case have been rejected in other cases that the court perceived as abusive (where the court perceived that the parties were making transfers of almost all of the decedent's assets shortly before death just to get an estate tax valuation discount.) Perhaps it is the fact that the tax reason totally dominates, that the court finds that the other nontax reasons are not "legitimate and significant."

(4) Legitimate and Significant Nontax Reasons. Planners often search to find what nontax reasons will be viewed as acceptable by the courts. This is obviously a fact intensive issue, considering all of the surrounding circumstances. However, it is comforting to planners that the reasons that were accepted in this case would apply in many family situations (i.e., joint management, keeping assets in a single pool rather than dividing the assets among estate beneficiaries to facilitate investment opportunities, and to facilitate providing equally for descendants).

(5) Creditor Planning. The court continues the record of almost all courts in failing to find creditor planning as a legitimate and significant reason. Unlike some cases, the court does not question that there can be legitimate creditor planning advantages of using LLCs, but the court just finds that on the facts of this case, that was not a significant reason.

(6) Facilitating Gift Giving. This is the first case that has recognized that reasons to facilitate making gifts and distributions among descendants in an advantageous manner can be a "legitimate and significant reason" to support a finding that the bona fide sale exception applies. Bongard found that facilitating giving was not a nontax reason under the facts of that case, and some other Tax Court Memorandum cases have subsequently said that facilitating giving can never be a legitimate and significant nontax reason. However, the three nontax reasons recognized in this case all relate to being able to divide one's assets among distributees in an effective way. None of the three reasons directly aid the decedent during her lifetime. All three provide perceived advantages for her children (i.e., allowing the daughters to jointly manage the assets, allowing the daughters to have the benefit of a large single pool of assets by keeping all of the decedent's assets in a single pool, and facilitating equal division of the assets).

Footnote 45 directly addresses the "facilitating gifting" issue:

> "In Estate of Bongard, we did not conclude that an intention to facilitate lifetime giving may never be a significant nontax factor. Rather, we found on the record presented there that such an intention was not a significant nontax reason for forming the partnership involved in that case."

(7) No Business Purpose Requirement. Despite their failure to convince a majority of the Tax Court in Bongard to impose a business purpose requirement to satisfy the "bona fide sale" requirement in the §2036 exception, some judges have continued to restate the standards of the exception as requiring a business purpose. (For example, see the Rosen and Rector cases.) Judge Chiechi explicitly repudiates the necessity of requiring activities that rise to the level of a "business" to meet the §2036 exception.

(8) No Outside Contributions to Partnership. Planners often debate whether it is better to have third parties make contributions to the partnership. Doing so can benefit the decedent during his or her lifetime, and may provide another nontax reason for forming the LLC or FLP. Furthermore, the Ninth Circuit opinion in Bigelow literally required that there be a joint pooling of assets — which would require substantial contributions by others (even though that did not happen under the facts of that case and the court did not point out that fact.) Judge Laro's opinion in Rector seems to disregard the Bongard analysis of what is required to constitute full consideration, and instead looks to whether there is a change in the underlying pool of assets or prospects for profit. That would also seem to require outside contributions.

In Mirowski, there were no contributions from third parties, and the court still upheld the LLC against an attack under §2036.

(9) No Negotiations; Only One Attorney. Some courts (including the Eight Circuit in Korby) have listed various factors supporting the failure to apply the bona fide sale exception, including "standing on both sides of the transaction" and the fact that only one attorney represented all participants. The court specifically rejected the "standing on both sides of the transaction" argument in Mirowski, but it was a single member LLC. Also, no mention was made of the fact that one attorney planned the transaction, knowing the agreement was being prepared with the contemplation that the daughters' trusts would quickly receive member interests by gift.

(10) Requirement to Distribute Cash Flow. The operating agreement requires the distribution of cash flow, which is defined as meaning cash flow after retaining reasonable reserves. Some planners question whether that increases the likelihood of an attack under §2036(a)(1). We cannot tell much about that from this case, because the court did not address §2036(a)(1) as to the contributions to the LLC in light of the fact that the §2036 exception applies. However, the existence of that requirement, rather than just giving the manager the discretion to make distributions, appears to have helped with the §2036(a)(2) and 2038 arguments. The IRS tried to force an argument that a power to determine the timing and amount of distributions somehow constituted a §2036(a)(2) or 2038 power over the transferred LLC interests. The court found that provision to be subject to other provisions of the agreement, all of which contemplated pro rata distributions under a fiduciary duty.

(11) Discretion to Determine Holdback For Reserves Before Distributing Cash Flow. Footnote 62 indicates that the IRS argued that the decedent had the power to determine how much cash flow and capital proceeds would be distributed by reason of the general manager's power to determine reasonable reserves. The court responded, first, that the discretion in determining reasonable reserves "was limited to establishing reserves for MFV's liabilities and obligations and future

expenses, debt payments, capital improvements, and replacements". Second, the decedent's authority to establish reserves "was subject to the fiduciary duties imposed on her by Maryland law". The court found nothing in the record suggesting that the decedent would have established reserves in violation of those duties. The court concluded that the decedent's power "as general manager to establish reserves as specified in MFV's operating agreement did not give Ms. Mirowski an interest or a right described in sec. 2036(a)(1) (or sec. 2036(a)(2))".

(12) Decedent as Sole General Partner. Planners generally avoid having the decedent serve as the sole general partner. However, that did not prevent a taxpayer victory in this case. In fact, the IRS did not even seem to argue that merely being the sole general manager (or the sole general partner in an FLP context) itself would be sufficient to invoke §2036(a)(2) or 2038. The court emphasized the limitations on the general manager's powers under the agreement and emphasized the fiduciary duties that applied to the general manager under state law. However, until there is more specific and general repudiation of Judge Cohen's reasoning in the Strangi Tax Court opinion, cautious planners will continue to be sensitive about having clients serve as the sole general partner of an FLP or manager of an LLC.

(13) Anticipated Distributions of LLC Income. Planners often ask if the entity should be able to distribute income receipts, similar to the way that the decedent would be able to receive dividends from stock that the decedent purchases. Some courts have pointed to the fact that some distributions were made to the decedent as reflecting an implied agreement of retained beneficial enjoyment of the FLP assets. In this case, the court specifically acknowledged that the decedent anticipated receiving distributions attributable to her share of the millions of dollars of royalty payments that would be made each year to the LLC. The court used that as supporting that the decedent had a method for paying anticipated expenses when the LLC was formed (i.e., the large gift tax liability) without having to access capital of the LLC.

However, planners cannot rely being able to expect distributions of LLC income without impacting the determination of an implied §2036(a)(1) right to beneficial enjoyment, because the court did not reach the §2036(a)(1) analysis as to the contributions to the LLC. (The court only discussed §2036(a)(1) as to the gifts of member interests, where the issue is whether there was an implied agreement to receive distributions of income or other assets attributable to the interests that had been transferred by gift.)

Nevertheless, it is an interesting situation that the court found that the decedent in this case anticipated receiving substantial distributions of income from the LLC, yet the LLC still passed muster under §2036 (albeit because of the §2036 exception).

(14) Not Retaining Enough Assets to Pay Anticipated Liability Directly From Retained Assets. A standard §2036 argument by the IRS is that the decedent did not retain sufficient assets to pay living expenses and other anticipated expenses. Here, the court said that the decedent did retain enough assets to provide for her living expenses, but did not retain enough assets to pay directly for her anticipated gift taxes. The court pointed to the facts that (i) there was no understanding that the LLC would make large distributions so that she could pay her gift taxes, and that (ii) she had other means of coming up with funds to pay the gift taxes, including anticipated large distributions from the LLC itself from royalties that would be paid to the LLC.

As with post-mortem distributions to pay estate taxes (discussed immediately below), the case will be cited by planners as rebutting the Erickson and Rector citations by IRS agents that use of FLP assets to pay transfer taxes creates an implied §2036 retained right.

Again, keep in mind that the case does not directly hold that distributions to pay gift taxes cannot evidence an implied agreement of retained enjoyment in assets contributed to the LLC — because the court did not address whether there was a retained enjoyment under §2036 as to contributions to the LLC in light of the fact that the §2036 exception applied.

(15) Post Mortem Distributions to Pay Transfer Taxes, Legal Expenses, and Estate Obligations. There are reports that IRS agents are now scouring FLP records to determine if any FLP assets have been used post mortem to pay estate taxes, in light of the Erickson and Rector cases. Erickson involved a situation where the FLP purchased estate assets and redeemed some of the estate's FLP interests, rather than having distributions of FLP assets to the estate, and the court relied primarily on the post mortem use of FLP assets to find the existence of an implied agreement of retained enjoyment under §2036. The court reasoned that people know they will eventually die and that there will be obligations after their deaths, so planning to use FLP assets to satisfy anticipated liabilities after one's death is a §2036 retained right. While Mirowski does not hold that post mortem use of LLC asset to pay estate taxes is not a §2036 retained right (in light of the fact that the §2036 exception applies so the court did not address §2036(a)(1) as to the contributions to the LLC), it is nevertheless an indication that post-mortem use of FLP/LLC assets to pay estate taxes is not necessarily fatal under §2036.

(16) Post Mortem Continuation of LLC to Carry Out Decedent's Goals. Perhaps an important factor in the court's perception that there were non-tax reasons for the LLC is that after the decedent's death the daughters actively worked together to manage the LLC assets, to make joint investment decisions, and to manage the patents licenses including related substantial ongoing litigation.

(17) Repudiation of "Integrated Transaction" Argument. The IRS has on occasion made the argument (for example, in Senda) that funding of an FLP must be coupled with the intention to make gifts in an integrated transaction analysis to treat the transaction as an indirect gift of the assets themselves. The IRS made a variation of that argument in Mirowski by saying the intention to make gifts meant that the transfer was not for "full consideration" and did not satisfy the §2036 exception. The court specifically rejected that approach, treating the transfer to the LLC and the subsequent gifts as two separate transfers for purposes of determining if full consideration was received.

(18) Glitch In Income Tax Reporting Is Not Fatal. Footnotes 32 and 46 indicate that the income tax return for 2002 (when the LLC made a large distribution just to the decedent's estate to pay the transfer taxes and other estate expenses) erroneously reported that the distribution was charged against the respective capital accounts of the members on a pro rata basis. The court merely observed that the record did not indicate why the return contained that error, but concluded that it did not find "that error to be a material factor in our resolving the issues presented".

(19) Coloring of the Facts. As with most of the FLP cases, reading the court's summary of the finding of facts clearly telegraphs which side will win. It was readily apparent reading the court's summary of the facts in Mirowski, before getting to the substantive opinion, that the taxpayer would win the case.

(20) Section 2036 Exception Applies If It Is Discussed First In The Opinion. Some planners have noted that if the §2036 bona fide sale exception is discussed in the opinion before the retained interest issue, the court finds that the exception applies. If the court first discusses the retained interest issue, it will ultimately find that the exception does not apply (and the court finds the existence of retained §2036 rights because courts seem to apply the same general standards for determining the existence of a bona fide transfer and the existence of an implied agreement of retained

enjoyment.) That pattern continues with this case. The exception is discussed first, and the court finds that it applies.

(21) Appealable to Seventh Circuit. One of the two personal representatives resides in Indiana (appealable to the Seventh Circuit) and the other resides in the United Kingdom. Presumably, appeal will lie to the Seventh Circuit (if the IRS chooses to appeal the case).

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PROTECT YOUR PET'S FUTURE

PET TRUSTS AND PET PROTECTION AGREEMENTS

Rachel Hirschfeld, Esq.

"The greatness of a nation and its moral progress can be judged by the way its animals are treated." Mahatma Gandhi (1869-1948)

People live longer, have more pets and treat them more like family than ever before. Americans 65 and older hold $15 trillion in assets,[1] the most in history for that age group. Approximately seventy-five million dogs and eighty-eight million cats are members of U.S. households.[2]

Pets are a central and vital part of their owners' lives. According to one survey, over two-thirds of dog and cat owners consider their animal companions members of their family,[3] and it is not uncommon to find animals listed in obituaries among a deceased's surviving relatives.[4] Just five years ago, sixty-four million American households owned at least one pet; today, that figure is seventy-one million.[5] In 1998, thirty-four percent of dogs slept in the same bed as their owners; today, that figure is forty-two percent.[6] Americans now spend $41 billion a year on their pets and that number is expected to reach $52 billion in the next two years.[7]

It is statistically established that seniors and people with health issues derive substantial benefits from their pets.[8] For example, owning a pet can lower blood pressure, increase exercise and circulation, reduce anxiety, boost mental acuity, and

enhance opportunities for social interaction.[9] Pets are also a distraction, so they can reduce the owner's stress and loneliness by causing the owner to focus attention on the pets needs.[10] Furthermore, it is well documented that the presence of pets in nursing homes increases the longevity of residents.[11]

Despite four significant trends — the aging of the U.S. population, the increase in pet ownership, the growing importance of pets in their owners' lives, and the increased spending on pets — pet owners often do not consider what will happen to their pets if their owner dies or becomes disabled. The consequences of an owner's failure to provide for a pet's continuing care can be stark. Too often, the pet will end up in a shelter, where, at best, it will not receive the care the owner would prefer; at worst – and in most cases –the pet will be euthanized.[12] In view of these grim facts, the Humane Society of the United States encourages pet owners to consider the consequences of failing to adequately provide for their pet.[13]

Many older people do not have pets because they are concerned about who will care for their pets if they become disabled or should their pet survive them. Often, older people would like to have a pet and would benefit from acquiring one or keeping the one they already have. If potential pet owners knew that there were methods of arranging for the security of their pets, they might feel more comfortable acquiring a pet.

In a perfect world, more seniors would adopt from animal shelters, thus helping to reduce the existing pet overpopulation crisis in this country. Many times,

when older animals with shorter life spans arrive in shelters, they have a lesser chance of adoption than puppies and kittens, despite the fact that mature animals may already be socialized and housetrained. Mature animals are often ideal candidates for older people whose lives could be greatly enhanced by the presence of an animal companion.

Although, in some families, the pet is a valued member of the household and the children, or some other relatives or friends, will continue to care for the pet, in others, there may be no family members left, or no one who wants to be bothered caring for the pet. Even where a friend or family member offers to care for a pet in the event of the owner's disability or death, the owner may feel more secure having a legally enforceable instrument.

Until recently pet owners encountered many legal barriers when trying to provide for their pets care after the owner's became unable to care for their pets. Fortunately, recent statutory developments in most states have removed those obstacles.

Pet owners can now create legally recognized and enforceable instruments that provide care for their pets in the event of the owner's disability and / or death. This article explains how estate planning practitioners can guide their clients in the creation and use of pet trusts and pet protection agreements[14], as well as how to draft wills with enforceable provisions concerning the care of animal companions.

Finally, this article alerts practitioners to specific considerations when drafting pet trusts, including how a pet trust is taxed.

The article concludes with some observations about the important role that pet trusts and pet protection agreements can play in helping elderly or disabled owners and their pets remain together, ensuring that the pets are well cared for, and establishing procedures for legally transitioning pet ownership.

Law Governing Estate Planning for Pet Owners, Past and Present

There is a growing interest among pet owners to provide for the care of their pets in the event of the owner's disability and/or death. Though estate planning for pets is by no means a new development, pet owners' attempts, over the years, to provide for their animal companions, were generally unsuccessful.[15] A basic understanding of the historical barriers to effective estate planning for pet owners illuminates the purpose and function of the tools today's pet owners can use to ensure their pets' continuing care.

Cases

Courts have employed various legal theories to void testamentary or inter vivos gifts for the benefit of pets. Courts have also frustrated the intent of many pet owners by holding that a direct gift to an animal is void because pets are classified as property, and property cannot legally own property.[16] The same reasoning applies to trusts in which pets are named as beneficiaries of funds or property.[17] Generally, only a person or a legal entity that is identified or definitely ascertainable may be the beneficiary of a trust. Hence, it logically follows that, since a pet cannot hold title to property, it also may not be a trust beneficiary.

Another impediment to effective estate planning for the care of pets is the trust law requirement that a beneficiary be able to enforce the terms of the trust. Although an exception to this requirement is made for charitable trusts, courts have traditionally distinguished a gift for the benefit of a specific animal from a gift for animals generally, and they have refused to enforce the former.

One enterprising pet owner tried to avoid these constraints by simply contracting with a friend to care for her dog after the owner's death. However, the court refused to sanction the arrangement and held that the decedent's written care instructions, which were accompanied by a check to be cashed after the decedent's death, were not a valid contract because the checks recipient, the pet's guardian, had not signed the instructions or furnished any consideration.[18]

Although courts in a few scattered cases had found valid some attempts to ensure pets' continuing care, courts usually stopped short of concluding that the arrangements were legally enforceable. One significant obstacle to effective estate planning for pet owners is the Rule Against Perpetuities, which requires that a trust be measured in human lives. As a result of this prohibition, many early decisions involving trusts established to protect animals held that the trusts were only honorary, meaning they were technically unenforceable. Since the pet guardian might not carry out an honorary trust, the pet remained vulnerable. In a similar vein, some courts have held that restrictions placed on a gift for the benefit of a pet were merely precatory and thus, by definition, not binding.[19]

In a few cases, courts have found that pet owners validly created gifts to human beneficiaries that were conditioned on the pet guardian taking proper care of the owner's pet. However, the favorable legal conclusion was often an empty victory, since, in most of these cases, the pet died before, or very shortly after, its owner, and no one was ever actually called upon to care for the pet.[20]

Development of Laws

In 1990, the National Conference of Commissioners on Uniform State Laws, faced with court decisions that almost universally held that pet owners' attempts to provide for the care of their pets after the owners' death or incapacity were either invalid or legally unenforceable, changed the Uniform Probate Code (UPC) to permit pet trusts.[21] Section 2-907 of the UPC was designed to authorize "a trust for the care of a designated domestic or pet animal and the animal's offspring."[22] The section (as amended in 1993) provides, in relevant part:

> (b) [Trust for Pets.] Subject to this subsection and subsection (c), a trust for the care of a designated domestic pet animal is valid. The trust terminates when no living animal is covered by the trust. A governing instrument must be liberally construed to bring the transfer within this subsection, to presume against the merely precatory or honorary nature of the disposition, and to carry out the general intent of the transferor. Extrinsic evidence is admissible in determining the transferor's intent.[23]

A number of states have adopted the UPC[24] in whole or part and have made the trust valid for the lifetime of the pet or its issue. Other states provide for termination after 21 years or when a living animal is not covered by the trust, whichever occurs earlier.[25]

Other states have based their legislation guaranteeing the validity of pet trusts on the Uniform Trust Code (UTC), which was adopted in 2000.[26] Section 408 of the UTC allows a trust for the care of an animal and authorizes courts to appoint someone to enforce the trust[27]:

(a) A trust may be created to provide for the care of an animal alive during the settlor's lifetime. The trust terminates upon the death of the animal or, if the trust was created to provide for the care of more than one animal alive during the settlor's lifetime, upon the death of the last surviving animal.

(b) A trust authorized by this section may be enforced by a person appointed in the terms of the trust or, if no person is so appointed, by a person appointed by the court. A person having an interest in the welfare of the animal may request the court to appoint a person to enforce the trust or to remove a person appointed.[28]

In total, thirty-eight states and the District of Columbia have enacted specific pet trust statutes, and pet trust bills are pending in five states.[29]

Providing for a Pet in the Event of the Owners' Disability or Death

Lawyers who practice estate planning generally have an intake questionnaire that they use to collect relevant information about their clients. For example, the questionnaire may ask whether the client is married and has children, elders or others who depend on the client. Practitioners should add the question "Do you have a pet?" to this list. Most lawyers do not think to ask this question. They also do not ask this question because they fear that if their client answers "Yes, I care about the welfare of my pet. Please protect my pet," they will not know how to secure the client's pet's safe future. However, when clients discover that their attorney cares about all aspects of their lives, they will be more loyal as clients and more likely to send referrals.

During the estate planning process, many pet owners and their attorneys write a will to pass the pet at the owner's death, but they often overlook the possibility that the pet owner may become incapacitated and thus unable to provide adequate care for the animal companion during the owner's lifetime. The goal of planning for disability is to execute legally enforceable documents that avoid costs, delays, and ambiguity.

Regardless of what instruments are used to accomplish this goal, the documents must give authority to appointed agents to act. However, as a general proposition, the drafter of any pet documents should avoid using the word "incapacity" because a pet owner may become unable to properly care for a pet, yet not legally be incapacitated as defined in guardianship statutes. For instance, a dog

owner may want the pet guardian to assist in caring for the dog if the owner cannot climb the stairs outside his home numerous times each day. An arthritic greyhound owner may want the pet guardian to begin acting in a limited role when the owner can no longer adequately exercise the dog. Another owner may want the pet guardian to act when the owner has difficulty remembering whether or not she fed the cat.

If the document uses the word “incapacity” to describe the owner’s possible mental state, it may trigger, or be used as evidence in, a guardianship proceeding. The documents might instead provide that the pet owner is deemed unable to care for their pet if and when two licensed physicians, who are independent of each other, or two named family members or friends, determine that the owner is not able to manage the pet’s care because of a physical deterioration. Additionally, the pet owner should be allowed to begin the enforcement of the pet trust and/or pet protection agreement at any time.

It is important to keep in mind that a will operates only after a pet owner’s death, while a health care proxy and power of attorney operate only before a pet owner’s death.

By contrast, pet trusts and pet protection agreements operate, both, during the pet owner’s life, including any period of disability or incapacity, *and* after the pet owner’s death.

Pet Trusts

A pet trust allows the pet owner to provide detailed instructions for the pet's care and direct the management and disbursement of trust funds, throughout the pet's life, which can vary in amounts and stages. Although funds are optional, any funds transferred to the trust during the owner's lifetime could stay in trust for the benefit of the pet at the owner's death. Additionally, the trustee, in his fiduciary capacity, has a legal obligation to carry out the terms of the trust.

A further benefit of establishing a pet trust is that the trust funds will not be subject to probate. As a result, the funds in the pet trust will not be considered when determining probate fees; disbursement of funds for the pet's care will not be delayed by the fact that the funds are controlled by the executor of the owner's estate; and the terms of the trust will remain private.

Moreover, a pet trust can actually help to keep the pet owner and pet together, whether the owner requires in-home care or moves to an assisted living facility or nursing home.

In order to both encourage compliance with the pet owner's wishes while the pet owner is alive, and increase the likelihood that more and more facilities will begin (or continue) to allow pets to stay with their owners, pet owners should strongly consider leaving a portion of the property that remains in the trust (and even for use during the pets life or after the pet's death) *pro rata* to any facilities that keep the owner and pet together during the owner's disability and until the owner's death.

Pet Protection Agreements

The Hirschfeld Pet Protection Agreement,™ created by Rachel Hirschfeld, Esq., is a legally enforceable written agreement between a minimum of two individuals or entities: the pet owner and the pet guardian or pet guardian organization. A pet owner can complete a pet protection agreement online at www.mypetprotection.com, with or without the help of an attorney. Attorneys may decide to use the pet protection agreement as an office form.

The pet protection agreement provides unlimited space for instructions regarding the pet's care as well as designating service providers, successor pet guardians, and a trust protector. The pet protection agreement urges the pet owner to name a shelter, sanctuary or rescue group as a retirement home that will take care of the pet upon the owner's disability or death in the event that neither the pet guardian nor the successor pet guardian are able to fulfill that role.[30] The goal is to ensure that every pet who has found a loving home has a secure future.

Although there is no obligation to provide funds for the pet's care, it is prudent to do so. Funds are usually set aside by means of a one-time payment that can be made at the time the pet protection agreement is signed or after the owner's disability or death.

Health Care Proxies

A health care proxy is valid *only* during the owner's lifetime. The health care proxy agent is permitted to access medical records which helps determine the

owner's inability to care for their pets and launches the period of the pet guardian's responsibilities. The health care proxy should include notice of the existence of all pet documents and pets. Often, in the midst of caring for the patient, the caregivers and health care proxy agent need to be reminded that there are also animals that need care.

It is advisable to laminate the health care proxy instructions on a wallet-sized emergency notification card, and to include the sentence, "I have pets at home that need care." If there are multiple pets, the owner may want to specify the number and include a description to ensure that all pets are located.

Powers of Attorney

A power of attorney is used to delegate financial authority to another during one's lifetime. A pet owner's agent should be given the authority and directions to deal with the pet and to expend funds to provide the pet with the desired level of care. The power of attorney may also give the agent authority to draft and fund pet documents. This language provides an additional reminder of the existence of a pet trust and/or pet protection agreement and the need to provide pet care. Attorneys can consider adding the following language to a power of attorney:

> I, (Name of Owner), do hereby appoint, my (Relationship, Name, Address and All Telephone Numbers of Agent) my attorney-in-fact; TO ACT:

FIRST: In my name, place and stead in any way which I myself could do if I were personally present with respect to the following matters, to the extent that I am permitted by (State) law to act through an agent:

“to care for any animals I have and to follow the instructions in a pet trust or pet protection agreement, if I have one;

to prepare a pet trust or pet protection agreement if I do not have one or if the one I have has expired or is otherwise not valid;

to expend funds for the care, safety and maintenance of my animals; and

to place my pets with temporary or permanent guardians if appropriate.

Wills

A “statutory pet trust” is a trust that is initiated by mention in a will. The statutory trust is a barebones plan that does not permit the pet’s owner to leave any instructions regarding the pet’s care. Nor does it allow the pet owner to direct how funds should be spent for the care of the pet. What it does do is trigger a pet trust according to state law. Thus, a provision in a will stating: “I leave the sum of $1,000 in trust for my dog, Soupbone’s, care” could trigger a statutory pet trust. Thirty-eight states and the District of Columbia have pet trust statutes. [31]

It is clear that merely including a bequest for the care of a pet in a will neither adequately, nor legally, ensures that the pet will be cared for in accordance with the owner's wishes after the owner's death.

Additional Planning Devices

A pet owner may use additional planning devices to ensure the proper care of a pet. Pets may be overlooked in the tumult that accompanies a person's unexpected illness, accident, or death, or during natural or manmade disasters.[32] In some instances, pets may be discovered in the home, lonely and hungry, days after the initial event. Owners can take steps to prevent this from happening.

Identify and Notify the Pet's Community

Identify a community of friends, family and shelters, sanctuaries and / or rescue groups for the pet in a pet trust. Name as many people as the owner knows who love animals in the pet trust and/or pet protection agreement. List their contact information, with permission, and distribute the pet trust and/or pet protection agreement to some of them.

The owner could choose from a few who agree to serve as emergency pet guardians or successor pet guardians if something unexpected happens to the owner. The owner could give one or two of these individuals' keys to the home, pet feeding and care instructions, and perhaps copies of the pet trust and/or pet protection agreement. Both documents contain information about whom to call and what to do for the pet, so that the pet has an easy waiting period or transition.

Pet owners could also open a small savings account with a pet guardian as a co-signator to ensure immediate care for pets in the event of an emergency.[33] The easy availability of these funds will help facilitate transporting the pet to the pet guardian or *vice versa*.

Additionally, a pet owner should make sure that neighbors, friends and relatives know how many pets there are as well as the names and contact numbers of the individuals who have agreed to serve as emergency guardians.[34] Pet guardians will know how to contact each other because this is detailed in the pet trust and/or pet protection agreement.

Emergency Notices

Owners should post removable "in case of emergency" notices on doors or windows specifying how many and what types of pets they have. These notices will alert emergency response personnel during a fire or other emergency. This is essential because pets may escape or hide during emergencies. The notice should also list emergency contact names and phone numbers and reference a pet trust and/or pet protection agreement. Because pets need daily care and will need immediate attention if the owner becomes disabled or dies, it is critically important to make arrangements to identify and care for pets under these circumstances.

What Tax Issues Arise as a Result of a Pet Trust?

There are income, gift and estate tax rules applicable to pet trusts.

Income Tax Rules

In general, the receipt of funds and other property (i.e., pet animal) by gift, bequest, devise, or inheritance is not income which is subject to federal income tax.[35] This means that when the pet and/or caretaking funds pass to the guardian or a trust for the care of a pet, they will not be taxable to the recipient. However, interest and dividends earned on the caretaking funds are subject to income tax.

Specifically, we need to address the income taxation of income earned on caretaking funds held in a pet trust. Generally, trust income is subject to income tax at graduated rates that mirror those of individuals.[36] However, unlike individual taxpayers who typically do not pay income tax at the highest marginal rate until their income exceeds $336,550,[37] trust income is subject to income tax at the highest marginal rate when it exceeds $10,050[38] which is a disadvantage to holding funds in trust.[39] Some commentators believe that a pet trust is subject to a more favorable tax rate (i.e., married filing separately), but based upon this author's analysis of Revenue Ruling 76-486 it would appear that pet trusts are subject to the regular trust income tax rates.[40]

Nevertheless, a pet trust is not taxable on trust income (other than capital gain) to the extent it is distributed to the pet's guardian; instead, the distribution is deductible by the trust and taxable to the guardian. When all is said and done, either the trustee or the guardian pays the income tax on trust income depending on whether trust income is accumulated or distributed each year.[41] If the pet owner's intention is to make the guardian whole for any tax liability associated with trust distributions, this needs to be taken into account when distributions are made.[42]

What if the pet, rather than a guardian, is the trust beneficiary? The IRS does not recognize a pet as a trust beneficiary and, so a pet cannot be taxable on trust distributions that it receives.[43] In addition, the guardian of the animal cannot be charged with the tax liability because the guardian serves only as an agent of the animal and does not consume the distributions for his own benefit (similar to a court appointed guardian of a minor or incapacitated person).[44] This could have created a lucrative tax loophole if no one (neither the pet nor its guardian) was subject to income tax on the trust income paid to or for the benefit of the pet.[45] The IRS quickly recognized the problem, and in Revenue Ruling 76-486 held that an enforceable pet trust established under a state statute is taxable on all of its income, regardless of whether any distributions are made for the benefit of the pet beneficiary.[46]

What are the tax ramifications if the pet is considered an asset of the trust, rather than a trust beneficiary indirectly through its guardian? If the pet is considered a trust asset, perhaps an argument could be made that any expenditures for the pet's care are deductible trust administration expenses which would reduce the trust's taxable income. IRC §212 allows a deduction for ordinary and necessary expenses incurred: (a) for the production of income; (b) for the management, conservation, or maintenance of property held for the production of income; or (c) in connection with the determination, collection, or refund of any tax. The accompanying regulations also state that a trustee may deduct expenses incurred "in connection with the performance of the duties of administration." In practice, trustee fees and professional fees (i.e., attorneys, accountants, and tax return preparation) are clearly deductible; but expenditures incurred for the care of a pet, which is not an

income-producing asset and is not inextricably related to the normal business of administering a trust, are probably not deductible.

Gift, Estate and Inheritance Tax

Under the current federal gift and estate tax law, a taxpayer may, through a combination of taxable gifts made during his life or at death under his will, transfer a certain amount of cash and/or property to heirs without incurring federal gift or estate taxes. Under the current statute, for gift tax purposes, this exempt amount is one million dollars. For estate tax purposes, the exemption is currently two million dollars, but will rise to three and one half million dollars in 2009; in 2010, the estate tax is repealed, only to return again with a one million dollar exemption in 2011. Many estate planners posit that there will be some change in the law prior to 2010.

Within this general framework, it should be noted that any amount passing to a pet trust by reason of the settlor's death will be subject to estate tax. In Revenue Ruling 78-105, 1978-1 CB 295, the IRS ruled that no portion of an amount passing to a valid trust for the lifetime benefit of a pet qualifies for the charitable estate tax deduction, even if the remainder beneficiary is a qualifying charity.[47]

The amount passing to pet trusts is not subject to state inheritance tax. In *In re Seabright's Estate*,[48] the issue was whether an honorary trust was subject to Ohio inheritance taxes. In that case, the decedent bequeathed one thousand dollars for the care of his dog, which was to be paid to the dog's guardian at the rate of seventy-five cents per day. In determining the inheritance tax due, the trial court found that

the Ohio inheritance tax statute did not authorize the levy of a tax upon property passing to or for the use of an animal and therefore the bequest to the dog was not taxable. However, any funds remaining at the dog's death was taxable in the hands of the remaindermen. The appellate court held that it could not levy a tax on the bequest intended for the care of the dog since it was not property passing for the use of a "person, institution or corporation."

Drafting a Pet Trust

As a structured, legally-enforceable instrument, a pet trust is the best tool to ensure that a pet will remain with its owner through the owner's disability; receive care in strict accordance with the owner's wishes; control detailed expenditure of funds for the pet's care; and invest funds with a view toward growth of principal for future use for the pet, heirs and possible charitable contributions. Accordingly, there are many issues to consider when drafting a pet trust.

Identifying the Pet Beneficiaries

First, in order to ensure positive recognition, the pet trust should identify the pet in detail by color, size, shape, breed (or mix thereof), markings, any other salient physical characteristics (such as eye color), habits and personality so as to permit third parties to identify the pet. In some cases, merely recognizing the pet by unique physical attributes is sufficient. In other cases, the pet may not be distinguishable from other animals of the same species. In either case, the owner should consult a veterinarian about implanting a microchip; applying a tattoo; or obtaining a DNA

report. Such precautions are relatively inexpensive and are also useful if the pet is lost, stolen, or involved in an attack (pet on pet or pet on human). Avian DNA testing is helpful in gender determination, because it is a non-surgical tool used by veterinarians, breeders, and bird owners who otherwise cannot determine the gender of their bird by its physical appearance or characteristics. Finally, these precautions can help prevent the pet's guardian from replacing the original pet with a new one so as to fraudulently extend rights to trust distributions or benefits.

Including "future pets" in the terms of the trust saves the effort of having to formally amend the trust or create a new trust whenever a new pet enters or leaves the picture.

Financial Considerations: Funding the Trust and Making Distributions

Some owners may have questions regarding the appropriate amount to leave for the care of a pet. The answer depends on various factors, including the type of pet, pet's age, health, lifestyle, estimated lifespan (an especially important consideration for species with a long lifespan such as certain birds and reptiles), as well as the total number of pets covered by the pet trust. The amount of funds also depends upon how much care the owner wishes the animals to receive if, for example, the animal is diagnosed with a serious illness such as cancer, diabetes, hip dysphasia, or other ailment. The owner should specify the level and duration of treatment that the pet should receive, as well as the preferred veterinarian or animal hospital. The pet owner may also wish to consider cremation, burial, and memorial expenses.

Pets can be expensive even where there are no emergencies: owners should consider the cost of pet food, grooming, routine veterinary care, boarding and kennel fees, sitters and walkers, toys, travel and mode thereof,[49] cost of living and inflation, and even reimbursement for extraordinary expenses such as the installation of a fence around the pet guardian's property. The pet owner should also determine who will receive compensation for caring for the pet.

Practically speaking, as the amount of caretaking funds passing to the trust increases, so does the likelihood that disgruntled heirs will challenge its terms. Because state statutes permit the court to reduce the amount of property transferred if it substantially exceeds what is required for the intended use,[50] a pet trust should explain, in detail, the reasons for leaving a sizable amount for the pet's care. The owner may want to cite examples of the owner's expenses for the care of the pets; stipulate that the owner desires to provide the pet a luxurious lifestyle – spell out what that means; and specify that trust funds should be used to provide medical care such as open heart surgery. As long as the amount transferred to the trust is fully justified and beneficiaries are named for the remainder, the court will probably leave the trust untouched.

It is important to identify other assets to be used to care for the animal companion. While it may seem like common sense to say that the "cage should go with the bird," the scope of assets to be used for the care of the pet may be, in the eyes of many pet owners, much broader and of greater value (for example, the owner may wish to leave the house in which the pet presently resides for the continued use

of the pet guardian and pet). The drafter should not assume anything and should make these provisions as clear as possible.

There are a number of ways to structure distributions. The easiest way is to provide that a flat amount be paid on a periodic basis with additional funds “as needed.” If the pet owner simply leaves a set amount to be disbursed regularly, and if the amount is too small, the pet guardian may not have sufficient funds to cover the pet’s expenses; conversely, if the amount is too large, the pet guardian may be motivated by greed rather than the best interests of the pet.[51]

The Pet Guardian

When establishing a pet trust, the owner should carefully consider who will physically assume care of the pet when the owner is no longer able to fulfill that role. The pet guardian will ultimately receive the funds from the pet trust for the benefit of the pet, by way of the trustee. The person chosen should be trustworthy and able to care for the pet in a manner consistent with the love, affection, and care that the owner provided. The owner should make sure the potential pet guardian is willing to accept this responsibility and signs the pet trust and /or pet protection agreement. The owner may also want to consider whether the potential pet guardian has the wherewithal to care for the pet (for example, a large, active dog accustomed to living in the country may not be comfortable if bequeathed to a person residing in a studio apartment in a big city).

When selecting pet guardians, ideal potential homes may include adult children, parents, brothers, sisters and friends who are acquainted with the pet and

have successfully cared for pets themselves. The owner should also select one or more successor pet guardians in the event the first is unable or unwilling to care for the animal.

One consideration that will have a significant impact on the choice of pet guardians is the fact that pets that have been raised together and/or otherwise bonded with one another, are generally happier if kept together. The owner of more than one pet should make his intentions clear as to whether keeping the pets together is an option or a goal and future pet guardians should agree to take all pets if the owner so wishes.

Regardless of how many pet guardians and successors are named, however, the owner should be advised to research pet retirement homes. These not-for-profit, no-kill shelters and sanctuaries offer a number of advantages. First, the organization could act as temporary or permanent pet guardian in the event all previously named pet guardians are unavailable or unable to act. Second, the shelter or sanctuary could have standing in the courts to act as a pet guardian if the named pet guardians are no longer available. Third, the entity could assist in finding a new family home for the pet, if needed. Often shelters and sanctuaries have their own bylaws and it is recommended that the owner review the above with them before choosing a retirement home.

The Fiduciaries

The Trustee

The trustee transfers the pet to the pet guardian and distributes the funds to the guardian to use for the pet's benefit. The trustee should be a person willing to administer the trust's funds for the pet's benefit and should be an animal lover. The owner might wish to pay fees for the services rendered by the pet guardian and trustee. However, the pet owner should be cautious to insure there are sufficient funds for the life of the pet, including any emergency medical needs. A successor trustee should also be named, so that it is not necessary to seek court intervention if the primary trustee is unwilling or unable to act; alternatively, the owner may give the trustee power to name a successor trustee. In any event, as with the selection of the pet guardian, the owner should discuss the matter with the proposed trustee before the documents are executed. In most cases, it is best if the pet guardian and the trustee are different people, so that each can be available to support the other and ensure that the other is acting in the pet's best interest.

Because one of the primary roles of the trustee is to supervise the responsibilities of the pet guardian, the trustee should be required to periodically check on the pet and the premises where the pet is housed. The owner may also wish to consider giving the trustee the power to choose a guardian for the pet in the event that all designated pet guardians are unavailable. Furthermore, depending on the size of the trust and the relationship of the parties involved, the owner could give the trustee the power to purchase a residence for the pet and its guardian. The owner may choose to relieve the trustee of certain fiduciary duties which would normally apply. For example, the trustee might be excused from having to post a bond or other security. If the pet guardian does not provide adequate care for the pet,

then the pet trust should allow the trustee to remove the pet guardian and replace him with the successor guardian, without the necessity of court intervention.

The Trust Protector

The Trust Protector's powers can take any form, limited only by the wishes of the Grantor(s) and their imagination. Generally, the powers granted the Trust Protector are the ability to remove or replace the Trustee and the ability to change the Trust's situs to take advantage of law changes or necessary steps to act in the best interest of beneficiaries if they move from low tax states to high tax states

Distribution Trustee

For larger trusts, it is recommended that a distribution trustee be used to provide both specialized investment skills and an added layer of oversight over the trust funds.

Defining the Care the Pet Should Receive

The owner should leave detailed instructions in the trust document regarding the pet's care, much like a parent, leaving for a long trip, would provide to a babysitter. These instructions should cover such topics as feeding (including the brands fed, amounts and feeding times), housing, grooming, medical care, toys and boarding. Additional details may include daily routines (including walks, other exercise periods[52] and socialization) as well as the names, addresses and telephone

numbers of service providers such groomers and walkers, to name but a few. The owner may want to establish more specific standards for the pet's care, such as specifying how often the pet is to receive veterinary check-ups and who is to receive reports of the veterinarian visits. The owner can be very creative as long as the directives are not unreasonable with respect to the pet's care considering the amount of funds available, and that the standards are flexible enough to cover unforeseen contingencies. A detailed pet trust will ease the transition for the pet and the pet guardian and protect the pet guardian's spending in event that questions arise. On the other hand, it is also important to allow the pet guardian to exercise discretion when faced with new circumstances, as long as discretion is exercised in the pet's best interests.

One potentially controversial issue is euthanasia, particularly if the pet guardian's interest in the trust terminates upon the pet's death. The owner could set forth the circumstances when euthanizing the pet would be appropriate (for example, when two independent veterinarians certify that the pet is terminally ill or will experience significant physical suffering and a significant decline in quality of life if not euthanized). Alternatively, the owner could indicate who has the discretion to make that decision (*i.e.*, the trustee, the pet guardian, or both). On occasion an owner may wish their pets euthanized upon the owner's death, but this is unlawful unless in the pet's best interest.

In most cases, the owner has preferences concerning the disposition of the pet's remains after its death (*i.e.*, cremation versus burial; memorial; and even the

use of a particular pet cemetery). The terms of the trust could expressly include such provisions.

The Remainder Beneficiary and Termination of the Trust

The trust could designate a remainder beneficiary or beneficiaries or, at the very least, provide a mechanism for the trustee to designate a remainder beneficiary or class. In making this decision, the owner should consider that the remainder beneficiary's financial interest in the trust may run counter to the pet living a long or short life. For this reason, the owner could consider including in the class of remainder beneficiaries, not-for-profit, no kill shelters or sanctuaries that have a stated purpose of caring for animals. Presumably, such organizations would refrain from challenging the available caretaking funds as being too generous or the liberal use of such funds by the trustee or pet guardian for the pet.

Finally, the trust should provide when it is to terminate. The substance of this provision will depend on applicable Rule Against Perpetuities and state statute.[53] Additionally, the trustee or pet guardian should be entitled to write another pet protection agreement and/or pet trust consistent with the intent the existing pet protection agreement and/or pet trust, if the pet or its issue is still alive, in order to protect the pets.

Conclusion

Pets have become an increasingly important part of the modern family. Many pet owners view their animal companions as valued members of the family and treat them as such.

Pets reciprocate with unconditional love and become accustomed to the lifestyle they enjoy with their owners. Like people, pet develop routines. Unfortunately, in the past, the owner's death or inability to care for an animal companion meant, at best, an uncertain future for the surviving pet. Too often, pets end up in shelters (with a fairly high likelihood of death).

There are two kinds of animals: those who are abandoned and abused, and those who are raised in loving homes. The goal for those pets who are raised in loving homes, and the reason their owners write pet trusts and/or pet protection agreements, is to ensure a loving future and a smooth transition to a life chosen by the owners, with people who will care for and about those pets. Once an owner has adopted a pet, regardless of the way the pet came to the owner, the owner is responsible for that pet for the rest of that pet's life. A pet trust and/or pet protection agreement helps the owner fulfill this duty.

Family members and friends can be a source of tremendous support when an owner dies or becomes disabled. However, although well meaning, they may not be able to follow through on informal commitments that they have made. Reasons for this may be beyond their control, such as allergies, difficult work schedules, lease restrictions, and the responsibility of extended families. In addition, their pets may not get along with the owner's pets.

Ultimately, the owner may feel more secure with an enforceable document than with a pledge or handshake as the foundation for a pet's continued care. Additionally, since pets are property, ownership and the transition thereof makes the switch smoother for all involved with an official record of the owner's intent.

For a substantial number of pet owners, it is important to secure their animals' continued care with careful estate planning. Today, pet owners can take a number of steps in the estate planning process to ensure that animal companions are well-cared for under all circumstances.

It is important for an owner to create a pet trust and and/or pet protection agreement that includes detailed instructions for the care of all animal companions. The pet trust and pet protection agreement should name a pet guardian who will take custody of the pet and follow the detailed instructions regarding the pet's care, as well as a successor pet guardian, trustee and successor trustee. Furthermore, if the pet trust does not include instructions for the conveyance of future funds, sufficient funds should be transferred to the trust or agreement for the pet's care.

Pet trusts and pet protection agreements are ideal tools to use to help owners and their pets remain together, to ensure that pets are well-cared for, and to establish procedures for legally transitioning pet ownership.

Rachel Hirschfeld, is the creator of the Hirschfeld Pet Protection Agreement and the Hirschfeld Pet Trust, the catalyst for which was Ms. Hirschfeld's beloved dog, Soupbone. She is an appointed member of the New York State Bar Association's Special Committee on Animals and the Law, the New York City Bar Association's

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The author would like to express her appreciation for the excellent assistance provided by Karen Goldfarb, Esq. for her tax expertise.

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[1] Time Magazine, *Numbers*, July 28, 2007, at 18.
[2] Diane Brady & Christopher Palmeri, *The Pet Economy: Americans spend an Astonishing $41 billion a year on their furry friends*, BUSINESSWEEK, Aug. 6, 2007, at 44, 47 [hereinafter *Pet Economy*].
[3] Cindy Hall & Suzy Parker, *USA Snapshots—What We Do For Our Pets*, USA TODAY, Oct. 18, 1999, at 1D.
[4] Rebecca J. Huss, *Separation, Custody and Estate Planning Issues Relating to Companion Animals*, 74 U. COLO. L. REV. 181, 230 (Winter 2003).
[5] American Pet Products Manufacturers Ass'n, Inc., *New National Pet Owners Survey Details Two Decades of Evolving American Pet Ownership*, available at http://www.appma.org/press_releasedetail.asp?id=109
[6] *Pet Economy*, *supra* note 2, at 46.
[7] *Id.*
[8] Studies on the benefits of pet ownership are available from the Delta Society (the Delta Society' mission is to improve human health through service and therapy animals) at: http://www.deltasociety.org/AnimalsHealthGeneralGeneral.htm

[9] *Id.*
[10] *Id.*

[11] *See* Anita Gates, *Pitter Patter of Paws Time-Tested Remedy*, NY TIMES, July 24, 2001 at F6.
[12] Almost four million dogs and cats are euthanized at shelters each year—nearly 9,600 per day. Humane Society of the United States, *HSUS Pet Overpopulation Estimates*, available at http://www.hsus.org/pets/issues_affecting_our_pets/pet_overpopulation_and_ownership_statistics/hsus_pet_overpopulation_estimates.html
[13] State Bar of Montana and the Humane Society of the United States, *Providing for Pets in Estate Plans*, 32 MONT. LAW. 9 (April 2007). [hereinafter "*Providing for Pets*"]
[14] TM & © 2007 Pet Protection Agreement, LLC. All rights reserved. Patent Pending.

[15] *See generally* Gerry Beyer, *Pet Animals: What Happens When Their Humans Die?* 40 SANTA CLARA L.REV. 617, 621-649 (2000).
[16] *See id.* at 629-30.
[17] Joseph D. Growney, *The Need For An Enforceable Pet Trust Statute in Missouri*, 72 UMKC L. REV. 1053, 1056 (Summer 2004).
[18] *Dailey v. H.C. Adams*, 319 S.W.2d 34 (Ark. 1958). The court also held that the document was not properly executed as a will and was not valid inter vivos gift because the transfer of funds was not irrevocable. *Id.* at 36, 37.
[19] *See generally* Gerry Beyer, *Pet Animals: What Happens When Their Humans Die?* 40 SANTA CLARA L.REV. 617, 621-649 (2000).

[20] *See id.*
[21] UNIF. PROB. CODE § 2-907 (1990).
[22] *Id.,* cmt.
[23] UNIF. PROB. CODE § 2-907 (1993).
[24] These states are Alaska, Arizona, Colorado, Hawaii, Illinois, Michigan, Montana, North Carolina, South Dakota and Utah.
[25] These states are Alaska, Arizona, Colorado, Iowa, Michigan, Montana, New Jersey, New Mexico, New York, Tennessee and Utah.
[26] Katharine Coxwell & Wanda D. Devereaux, *Paws Laws or How Nigel and Miss Muffy Came to Be Rich*, 67 ALA. LAW. 433, 439 (November 2006) [hereinafter "Paws Laws"]. These states are Alabama, Arkansas, Florida, Kansas, Maine, Maryland, Missouri, Nebraska, New Hampshire, New Mexico, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Virginia, Wyoming and the District of Columbia.
[27] National Association for Biomedical Research, Animal Law Section, *Pet Trusts*.
[28] UNIF. TRUST CODE § 408.
[29]For a list of pet trust statutes and pending legislation, along with some salient provisions of each state's enactment or bill, see Appendix A.
[30] Of course, a pet owner could name a shelter, rescue or sanctuary that has a retirement home as a primary or successor pet guardian, if he so wishes.
[31] *See* note 34, *supra*.
[32] Humane Society of the United States, *Preparing for the Unexpected* (2003-2007), available at http://www.hsus.org/pets/pet_care/providing_for_your_pets_future_without_you/a_preparing_for_the_unexpected.html
[33] Practitioners should advise their clients that a co-signer can access and deplete a bank account at any time.
[34] Humane Society of the United States, *Preparing for the Unexpected*, *supra* note 32.
[35] I.R.C. § 102.
[36] *Id.*
[37] This threshold applies to married taxpayers filing jointly in 2006. This threshold typically increases each year because it is inflation adjusted annually.
[38] This threshold, which is inflation adjusted annually, applies in 2006.
[39] I.R.C. § 1(e).
[40] Commentators appear to believe this because Rev. Rul. 76-486 provided that a pet trust is subject to the tax rates imposed by I.R.C. § 1(d) pursuant to I.R.C. § 641, and I.R.C. § 1(d) imposes the tax rates applicable to married individuals filing separately. I.R.C. § 641 specifies which tax rates are

applicable to estates and trusts, and because it referenced the tax rates under § 1 (d) at the time of the Ruling, the rates applicable to married individuals filing separately were also applicable to estates and trusts, not just pet trusts. However, I.R.C. § 641 was subsequently amended for tax years beginning after December 31, 1976 by replacing the reference to I.R.C. § 1(d) with § 1(e), with the effect that estates and trusts, including pet trusts, under the current tax law are no longer subject to the more favorable rates applicable to married individuals filing separately.

[41] *Paws Laws*, *supra* note 26, at 440.

[42] *Id.*

[43] Darin I. Zenov & Barbara Ruiz-Gonzalez, *Trusts for Pets*, 79 Fla. B.J. 22, 24 (Dec. 2005).

[44] *Id.*

[45] *Id.*

[46] *Id.* *See* Rev. Rul. 76-486, 1976-2 C.B. 192.

[47] Rev. Rul. 78-105, 1978-1 C.B. 295.

[48] 95 N.E.2d 779 (Ohio Ct. App. 1950).

[49] For example, and owner can specify that the pet should never travel in the baggage compartment of an airplane.

[50] These states are Alabama, Alaska, Arizona, Arkansas, Connecticut, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Michigan, Missouri Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, Oklahoma, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Virginia, Wisconsin, Wyoming and the District of Columbia.

[51] For example, a pet guardian receiving $10,000 per month may refuse to euthanize a pet that is very sick and in pain, even though such refusal might not be in the pet's best interest. *Id.*

[52] For example, a pet owner may specify that a labrador retriever should have an opportunity to "play fetch" for at least 30 minutes a day, weather permitting.

[53] *See* American Society for the Prevention of Cruelty to Animals, *Pet Trusts: State Laws*, available at http://www.aspca.org/site/PageServer?pagename=donate_planned_pettrustslaws
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First Report to the ABA of the Proceedings of the NCCUSL Drafting Committee on the "Insurable Interests Relating to Trusts" Uniform Act

Reported by David Neufeld, ABA Advisor to the Committee

March 1, 2008, Chicago, Illinois

On March 1, 2008, the NCCUSL Drafting Committee on the "Insurable Interests Relating to Trusts" Uniform Act (the "Committee") convened its first meeting, after two months of preliminary exchanges of emails among committee members, the ABA Advisor and observers. The scope of the Committee's task is narrow: to address the issues that came to light with the *Chawla*[i] case in a uniform manner among the several states, presumably as an amendment to the Uniform Trust Act, with the alternative possibility that it might be enacted in any given state as an amendment to a state's insurance code.

Background

It might be safe to say that until the District Court for the Eastern District of Virginia weighed in on the interpretation of the Maryland insurable interest law as it applied to insurance trusts ("ILITs") in 2005 most estate planning practitioners gave little thought about whether an ILIT could acquire a life insurance policy. In fact it was assumed that this just was the case. Whether such blissful ignorance across the industry was merited or not, that case opened a can of worms with its secondary ruling that the trustee possessed no insurable interest in the life of the insured and the policy was *void ab initio*. The world of estate planners was rocked. When the Court of Appeals for the 4th Circuit had a chance to address this issue and bring us back to bliss they went only part of the way. In affirming the decision on the basis of the primary ruling, it vacated the District Court's secondary ruling on insurable interest as unnecessary dicta. This helped the litigants but still left this gaping hole in ILIT related planning for everyone else. The fix then became legislative.

As of this writing six states have enacted legislation in an attempt to restore order. While some seem to share similarities and others are completely distinct, in fact each has its own unique characteristic. In essence we have six different approaches developing. In an article published in the ACTEC Journal by Mary Ann Mancini and Howard Zaritsky,[ii] the authors thoroughly analyze the history of insurable interest law, both generally and as it relates to trusts, discuss the *Chawla* case and dissect the legislative responses to *Chawla* thusfar, concluding with a call for a uniform and better approach than is already out there for providing for an insurable interest law relating to a trust as purchaser of life insurance. This article precipitated the current effort by NCCUSL.

The Scope of the Drafting Project

The "Project Proposal Form" from the NCCUSL Committee on Scope and Program states:

> . . . [T]he study committee has concluded that a drafting committee should be created to amend the Uniform Trust Code by developing a bracketed provision that addresses the use of life insurance trusts in estate planning in a manner to eliminate any issues about the validity of the life insurance policy because of the possibility the trustee or trust has no insurable interest in the life of the person who is the subject of the insurance.

Thus, the drafting committee will attempt to draft a provision that would provide ILITs with insurable interest as otherwise defined in the relevant state's laws. The scope does not extend to revising what is and is not an insurable interest generally, but rather to adapt ILITs to the existing law.

The drafting committee is composed of several commissioners and myself as ABA Advisor. In addition the Chairman has invited interested individuals and representatives from interested organizations as observers to provide their views during preliminary consideration of the project.

Results of the first meeting

The Committee defined two issues that might be addressed within the scope of its charge, defined in shorthand as "the *Chawla* issue" and "the STOLI issue."

The first issue easily fits within the Scope, with the most complicated issue being how to provide a trustee with insurable interest in situations where one might intuitively expect there to be insurable interest but closer scrutiny creates some doubt. For instance there seems to be uniform acceptance among practitioners that if, as is the case, spouses and children have an insurable interest in a spouse/parent so too does a trustee of a trust benefitting these same individuals. Also, of course, the insured always has an insurable interest in himself and therefore practitioners might expect that a trust created by the insured as grantor has an insurable interest in the grantor. But, the question was raised, what about the following situations, among others:

1. some, most or all of the trust beneficiaries might be individuals themselves without insurable interest, such as cousins, grandchildren and spouses of grandchildren;
2. the trust contains spray and other discretionary provisions that might result in trust beneficiaries not on the list of those with insurable interests receiving all of the trust assets; or
3. the trust grantor is not the insured and in fact the trust is an ancient trust created generations ago by a grantor no longer living.

The second issue, referred to in shorthand as the STOLI issue (STOLI being the acronym for "stranger owned life insurance," also referred to as "investor owned life insurance" or IOLI, among other names), deals with those insurance sales that on its face satisfy all legal requirements but whose underlying facts might support a finding that an investor arranged with an insured (or someone else with an insurable interest in the insured) to acquire a policy pursuant to a pre-existing plan to purchase the policy from the policy owner sometime after the policy is issued. This might be susceptible to attack on a form-over-substance argument or similar judicial tool, leading to a conclusion that the policy is void, as the true owner might be held to be the investor without an insurable interest. In the context of ILITs, a STOLI transaction might also arise in a situation where a trust beneficiary is obligated from the inception of the transaction to sell his beneficial interest in the trust to an investor. In this case the trust might have the requisite insurable interest in the insured but a thorough review of the trust beneficiaries and their legal obligations might indicate an arrangement intended to side-step the insurable interest law. Thus one concern of the Committee is whether the trust's insurable interest depends on who are the trust's beneficiaries, both nominally and in reality. If so then the bona fide nature of those beneficiaries may be considered as within the Scope. If not, or if the general application of the insurable interest law as in existence would handle this problem, then it would seem to be an external issue.

Among the working assumptions to come out of the first meeting are:

1. The Committee's efforts will focus on the trust grantor as analogous to the acquirer of the policy, such that if the individual who is grantor would have an insurable interest in the insured had he acquired the policy directly, then the trust/trustee has insurable interest, notwithstanding who are the beneficiaries (with a possible fix for the ancient trust issue).
2. Understanding that STOLI in the context of trusts concern two possible types of transactions (one being the acquisition of the policy by the trust with the intent of <u>selling the policy</u> to an investor, and the other being the acquisition of the policy by the trust with the intent of a trust beneficiary selling <u>the beneficial interest in the trust</u> to an investor) the Committee's effort will not concentrate

on those situations which concern whether the trust bought a policy with the intent of selling it but instead will, at most, consider issues arising from the sale of beneficial interests. This may prove to be an issue better handled in the context of general insurable interest law and not necessarily in the context of trusts, i.e. if the insurable interest law of a given state looks to, inter alia, who receives the insurance proceeds, then perhaps this already includes an examination of who receives trust distributions composed of those insurance proceeds. Whether the Committee covers sales of beneficial interests or considers it also to be better folded into general insurable interest law will continue to be reviewed.

The Chair parceled out responsibilities to three meeting participants to draft versions of legislation with alternative approaches, inviting others to contribute if they wish.

Request for input and suggestions

The role of the ABA Advisor is to be a resource to the Drafting Committee as well as a conduit of information between interested parties within the ABA and the Chairman of the Drafting Committee. In that regard I am soliciting input from interested Sections and Committees concerning the issues outlined herein. Our next meeting is scheduled for October/November 2008 although progress is expected to be made with interim correspondence.

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[i] *Chawla, ex rel Geisinger v. Transamerica Occidental Life Insurance Co.*, 2005 WL 405405 (E.D. Va. 2005), *aff'd in part, vac'd in part*, 440 F.3d 639 (4th Cir, 2006)
[ii] "Insurable Interests: Apres *Chawla*, le Deluge?" 32 ACTEC Journal 194 (2006).

Supreme Court Rules Participants & Beneficiaries Can Sue Fiduciaries Under ERISA §502(a)(2) To Recover 401(k) & Other Defined Contribution Account Losses: "Entire Plan Rule" Limited To Plans With Fixed Benefit Formula

The United States Supreme Court in *Larue v. DeWolff, Boberg & Associates, Inc.*, ruled on February 20, 2008, that although Section 502(a)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) generally does not provide a remedy for individual injuries distinct from plan injuries in plans providing "fixed benefits," ERISA § 502(a) does allow individual participants to seek to recover individually from fiduciaries for lost value to plan assets in a participant's individual account resulting from a fiduciary breach. The decision permits individual participants and beneficiaries to sue 401(k) and other defined contribution plan fiduciaries under ERISA § 502 to recover for individual account losses resulting from a fiduciary breach. Accordingly, companies sponsoring 401(k) and other defined contribution plans and the officers, directors, employees and service providers involved in the administration or oversight of these plans now are likely to face a greater risk of being sued for breach of fiduciary duty under ERISA by individual participants upset about a decline in the value of their individual plan accounts.

Section 502(a)(2) provides for suits to enforce the provisions of ERISA §409 concerning breaches of fiduciary duties that harm plans. The principal statutory duties imposed by §409 relate to the proper management, administration, and investment of plan assets, with an eye toward ensuring that the benefits authorized by the plan are ultimately paid to plan participants. Even prior to the decision, companies sponsoring 401(k) and other defined contribution plans and their leaders involved in plan related activities already faced significant liability under ERISA to private plaintiff fiduciary litigation and Labor Department fiduciary enforcement actions. See, e.g., Stamer, "Enron litigation has implications for plan sponsors and management", 401K Advisor (December 1, 2006).

Prior to the decision in *Larue*, however, defendants in ERISA fiduciary breach actions frequently were able to rely upon the Supreme Court's holding in *Massachusetts Mutual Life Insurance Co. v. Russell* that ERISA §502(a)(2) only authorizes recovery only by the plan as an entity (the "entire plan rule") and does not permit individuals to bring suit when they do not seek relief on behalf of the plan as a shield against suits brought by individual participants seeking damages for losses in the value of their plan accounts.

In the majority opinion written by Justice Stevens joined in by Justices Souter, Ginsburg, Breyer, and Alito, however, the Supreme Court majority ruled in *LaRue* that this entire plan rule does not bar actions by an individual participant seeking relief for losses in the value of their individual defined contribution plan account resulting from a fiduciary breach.

According to the majority opinion written by Justice Stevens, a breach of fiduciary duty action brought by a participant or beneficiary whose defined contribution account

lost value as a result of a breach of fiduciary duty is distinguishable from breach of fiduciary duty claims brought by a participant or beneficiary seeking relief for fiduciary breaches arising under plans providing a “fixed benefit” such as the disability benefit plan addressed in Russell or other defined benefit plan, where the plaintiff received all of the benefits to which the participant was contractually entitled, but sought consequential damages arising from a delay in the processing of the participant’s claim. The Majority opinion written by Justice Stevens states that Russell's emphasis on protecting the "entire plan" reflects the fact that the disability plan in Russell, as well as the typical pension plan at that time, promised participants a fixed benefit. Misconduct by such a plan's administrators will not affect an individual's entitlement to a defined benefit unless it creates or enhances the risk of default by the entire plan.
In contrast, the Supreme Court majority found Russell's "entire plan" references, which accurately reflect ERISA §409's operation in the defined benefit context, to be “beside the point” in the defined contribution context. In the case of actions seeking recovery for losses to individual defined contribution accounts, the Majority reasoned whether a fiduciary breach diminishes plan assets payable to all participants or only to particular individuals, it creates the kind of harms that concerned §409's draftsmen. Consequently, the Supreme Court concluded that for defined contribution plans, fiduciary misconduct need not threaten the entire plan's solvency to reduce benefits below the amount that participants would otherwise receive. Accordingly, the Supreme Court found that Russell’s entire plan rule did not bar the participant’s suit to recover individually for losses to this individual defined contribution account allegedly resulting from a fiduciary breach.

The opportunity allowed under Larue for individual participants and beneficiaries to seek to recover individually, rather than on behalf of the plan as a whole, when their individual plan accounts lose value due to a fiduciary breach increases the likelihood that individual participants and beneficiaries will sue defined contribution plan fiduciaries for breach of fiduciary duty just as Labor Department fiduciary regulations for defined contribution standards are evolving and substantial market volatility creates a heightened risk of losses in account values. As a result, the *LaRue* decision further reinforces the need for defined contribution plan fiduciaries to exercise care to act, and be prepared to defend the adequacy of their fiduciary actions under ERISA.

You can find additional resources and information about ERISA fiduciary responsibility exposures and developments by logging in to the resources available on CynthiaStamer.com.

About Cynthia Marcotte Stamer
Vice Chair of the ABA Real Property, Probate & Trust Section Employee Benefits & Compensation Group and Board Certified In Labor and Employment Law by the Texas Board of Legal Specialization, Cynthia Marcotte Stamer has more than 20 years experience helping employers and business leaders, employee benefit plan fiduciaries and administrators, insurers and others design, implement, administer and defend employee benefit and compensation, insurance and other human resources practices, policies and strategies. Ms. Stamer is recognized for her work helping clients design,

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