REAL
ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e|Report

A Bi-Monthly Electronic Publication for Section Members

Trust and Estate News

April 2009

Trusts, Estate Planning And The Family Jet

When a high-net worth family or individual is purchasing a jet that will be flown primarily for personal and family use, it can be useful to consider at the outset how the structure of the ownership and operation of the aircraft fits within the estate plan of the owner and any future ownership or usage by his or her heirs.

Early planning may help avoid the need for future transfers of ownership of the aircraft. Most States impose taxes on transfers of aircraft, and there may also be other state and federal tax issues involved. These often arise when trying to restructure the ownership of the aircraft and transfer it to a trust in order to satisfy estate planning needs.

Despite the many limitations on aircraft ownership and operations contained in the Federal Aviation Regulations, the US Federal Aviation Administration (FAA) does allow registration of an aircraft in the name of a Trustee of a trust. The FAA has requirements for Trustee's of trusts which own aircraft. Under FAR 47.7(c), each Trustee of the trust must be either a U.S. citizen or a resident alien. They must also submit an Affidavit of Citizenship from each Trustee and a copy of the Trust Agreement to the FAA. The Federal Aviation Regulations (FARs) also require that they submit a “copy of each document legally affecting a relationship under the trust.”

There are special requirements which must be met if any beneficiary is not either a U.S. citizen or a resident alien. An Affidavit is required from each Trustee stating that “the trustee is not aware of any reason, situation, or relationship (involving beneficiaries or other persons who are not U.S. citizens or resident aliens) as a result of which those persons together would have more than 25 percent of the aggregate power to influence or limit the exercise of the trustee's authority.”

If persons who are neither U.S. citizens nor resident aliens have the power to direct or remove a Trustee, either directly or indirectly through the control of another person, the Trust Agreement must provide that those persons together may not have more than 25 percent of the aggregate power to direct or remove a Trustee. However, the regulation does not prevent those persons from having more than 25 percent of the beneficial interest in the trust.

Trusts, frequently called “owner trusts” are commonly utilized to own and register an aircraft in the United States. If an existing trust or a trust organized for a different purpose is later utilized to own the aircraft, the Trust Agreement may need to be amended in order to satisfy the FAA requirements mentioned above. The FAA must approve all Trust Agreements used to register an aircraft. As such, confidentiality of the terms regarding other assets held in a trust which has multiple purposes can be a concern if an aircraft is added to an existing trust.

Addressing aviation issues in the trust created to meet other estate planning and family needs can quickly become complex. Deciding how to best handle each issue varies from person to person. Consulting an attorney experienced in corporate jet registration and operations can assist by providing guidance on how to ensure FAA compliance while satisfying estate planning goals.

Michelle M. Wade and Dillon L. Strohm are attorneys with the law firm of Jackson and Wade, L.L.C. and counsel clients on the acquisition, financing and operation of corporate jets operated under Part 91 and Part 135 of the Federal Aviation Regulations. Jackson & Wade, L.L.C. can be found at www.jetlaw.com.

WHERE THERE'S A WILL, THERE'S A . . . DUTY?:

A CLOSER LOOK AT THE SAFEKEEPING OF CLIENTS' ORIGINAL ESTATE PLANNING DOCUMENTS

Jennifer A. Kosteva

Before the ink has dried on their newly executed wills, clients often ask their attorneys and other advisors where they should store their original estate planning documents. A number of options are available, each with their own advantages and disadvantages. The options for storing original estate planning documents include in the client's home safe, in the client's safety deposit box at a bank, with the drafting lawyer, with the named fiduciary, with a trusted family member, friend, or advisor, or in some jurisdictions with respect to wills, with the clerk or registrar of the appropriate court. This article examines the duties of a lawyer who retains a client's original estate planning documents for safekeeping. The article also considers safekeeping by a bank, trust company, or other financial institution serving as a fiduciary under a will or trust, or as an advisor to the client.

Introduction

The law governing the retention of original estate planning documents varies from state to state. Some states have affirmative laws imposing certain duties on persons in possession of original wills. In other states, the state bar associations have issued ethics opinions on the retention of original estate planning documents. Yet many states provide little or no guidance on the issue. The following discussion draws upon various state laws, legal ethics opinions, and legal treatises. The safekeeping lawyer should become familiar with the laws in the lawyer's state in working to establish "best practice" policies. Likewise, a bank, trust company, or other financial institution serving as the custodian of original estate planning documents should considering adopting policies akin to those rules applicable to lawyers in their respective states.

I. The General Rule

Generally speaking, the safekeeping of a client's will does not create any additional duties for the drafting lawyer, such as exercising vigilance to learn of the client's death or otherwise causing the will to be submitted for probate. See Scholen v. Guaranty Trust Co. of New York, 288 N.Y. 249, 43 N.E.2d 28 (1942) (leading case); see also 79 Am. Jur. 2d Wills § 734; Annotation, Duty and Obligation Assumed by Trust Company or Other Person to Which Will is Delivered for Safekeeping, 141 A.L.R. 1277. Additionally, the ACTEC Commentaries to Model Rule of Professional Conduct 1.8 state that the mere retention of a client's original estate planning documents does not make the client an "active" client or impose any obligation on the lawyer to inform the client of tax law developments or to learn of any changes with respect to the client's family status or financial situation.

However, at least one court has indicated its willingness to impose additional legal obligations under contract theory where a lawyer makes certain representations to the client. For example, if a lawyer states to the client that he will monitor the obituaries for news of the client's death (or states that he has the means for such monitoring) or promises to otherwise cause the client's will to be probated after the client's death, the court stated that it would be appropriate to hold the lawyer to his end of the bargain. See, e.g., Scholen, 288 N.Y. 249, 43 N.E.2d 28.

Perhaps taking a cue from the Scholen court, the New York Bar Association has opined that whether a lawyer has additional obligations with respect to the safekeeping of a will is a matter of contract law. See N.Y. Ethics Op. 724 (1999). The contractual duty may be express or implied, creating a heightened need for the safekeeping lawyer to define clearly the custodial relationship. However, absent an express or implied agreement, the lawyer has no positive duty to learn of a client's death or to take other steps following the client's death. Id.; see also Mass. Ethics Op. 76-7 (1976).

II. The Common Exception: Notice of a Client's Death

A. State Law and the Uniform Probate Code

A number of states impose a positive duty on the custodian of a will upon receiving notice of the testator's death. Under these statutes, the custodian of a will must deliver the will to the executor named in the will or to the court having jurisdiction over the administration of the estate. See, e.g., Conn. Gen. Stat. § 45a-282; Md. Code, Est. & Trusts § 4-202; Okla. Stat. tit. 58, § 21; Wash. Rev. Code § 11.20.010; see also 79 Am. Jur. 2d Wills § 730. The Uniform Probate Code also requires any person having custody of a will to deliver the will to a person able to secure its probate (usually the executor) after the death of the testator. See Uniform Probate Code § 2-516.

The legislative intent behind these state statutes and the Uniform Probate Code is to encourage the probate of wills and to prevent persons from benefiting by refusing to probate an unfavorable will in their possession. The state statutes and the Uniform Probate Code refer simply to the "person having custody" of the will and do not distinguish between the lawyer as safekeeper for his client and other persons who may be in possession of a will. Thus, a corporate fiduciary in possession of an original will is under a legal obligation to produce the will to the appropriate court. Most states with such laws, however, only impose the duty upon actual notice to the will's possessor at the testator's death.

B. State Bar Ethics Opinions

Several state bar associations have issued ethics opinions addressing a safekeeping lawyer's duty upon notice of a client's death, and generally take one of two approaches. New York, for example, treats the safekeeping lawyer as having an ethical obligation to carry out the client's wishes. As discussed above, this obligation appears grounded in contract law and is based on the implied understanding between lawyer and client. In most cases, the New York Bar Association believes that there is an implied understanding between the safekeeping lawyer and his client that upon notice of the client's death, the lawyer will take steps to see that the will is given effect by notifying the executor named therein of the will's existence. See N.Y. Ethics Op. 521 (1980). The New York Bar Association further states that a lawyer may notify either the executor named in the will or the beneficiaries under the will, and that such notification does not violate the duty of confidentiality between lawyer and client. Rather, the client is deemed to have provided implicit authorization for such disclosure. See id.; N.Y. Ethics Op. 724.

Pennsylvania takes a different approach. The Pennsylvania Bar Association has opined that the safekeeping lawyer has an "absolute obligation" to take steps to cause a will to be probated upon notice of a client's death. See Pa. Ethics Op. 97-66 (1997). Pennsylvania views the safekeeping lawyer as an "officer of the legal system and a public citizen having special responsibility for the quality of justice." Id. Not causing a will to be submitted to probate is synonymous with conduct prejudicial to the administration of justice. Id. The seemingly strong language of this ethics opinion may be tempered somewhat by the particular facts presented to the state's ethics committee. In that matter, the executor refused to probate an unfavorable will known to be in the lawyer's possession in order to benefit himself. Whether Pennsylvania would impose the same ethical duty where no self-dealing was present remains unclear.

III. Best Practices for the Safekeeping of Original Estate Planning Documents

A. General Considerations

The American Bar Association has long maintained that it is permissible for a lawyer to act as the custodian of a client's original will. See ABA Informal Op. 981 (1967). However, some states have cautioned against the safekeeping of original documents absent a client's affirmative request because the lawyer may be perceived as impermissibly soliciting business. These states caution that the retention of original documents may exert pressure on clients to retain the same lawyer for future matters or on executors named within the documents to retain the lawyer with respect to estate administration matters. See, e.g., State v. Gulbankian, 54 Wis.2d 605, 196 N.W.2d 733 (1972); Tex. Ethics Op. 280 (1964). In most states, however, an informative discussion between the drafting lawyer and client regarding the lawyer's possible role as custodian does not raise an ethical concern so long as the lawyer does not exert influence over the client or the client's wishes. See, e.g., N.Y. Ethics Op. 521; Pa. Ethics Op. 01-300 (2001).

Because of these concerns and others, the client may wish to ask another party to retain his original estate planning documents. For example, a bank, trust company, or other financial institution can provide a secure place to safekeep original documents against loss or destruction. Moreover, the corporate institution will have ready access to the documents if its services are needed as a fiduciary under the will or trust.

B. Best Practices

Regardless of whether the drafting lawyer, a corporate institution, or another person retains the original estate planning documents, the safekeeper should adopt "best practices." These best practices, as enumerated by a multitude of sources including the ACTEC Commentaries, include the following:

- Provide written receipt to the client indicating the safekeeping of the document. The written receipt should:
    - Identify which documents are being stored;
    - State that the safeguarding of the documents is per the client's request;
    - Request that the client notify the safekeeper of any change in address; and
    - If a lawyer is serving as safekeeper, indicate that the fiduciary named in the documents is not required to retain the lawyer for assistance in administering the estate or providing other legal services.
- Provide a copy of the original documents to the client. The copy should be marked clearly as "copy" and indicate where the original documents are being stored.
- Advise the client that the client has the right to request and promptly receive the documents at any time.

- Define the nature of the custodial relationship (*i.e.*, no obligation of the safekeeping lawyer to review the client's estate plan; no obligation of the safekeeping lawyer or corporate fiduciary to learn of the client's death), including any steps the client should take. For example, the safekeeper might advise the client to inform close family members or friends of the location of the original documents.
- Retain documents in accordance with Model Rule of Professional Conduct 1.15:
    - Properly identify the documents;
    - Appropriately safeguard the documents in a safe, vault, safe deposit box, or other secure place where they will be reasonably protected against loss or destruction; and
    - Comply with the client's written direction regarding disposition of the documents.

A safekeeping lawyer or financial institution should consider clarifying the nature and extent of its custodial role with the client. Particularly when operating in a contract regime such as New York, the lawyer or financial institution should proactively avoid the creation of an inadvertent implied obligation. Although this conversation may be awkward or perhaps offensive to some clients, such discussion allows the client to make an informed decision regarding the safekeeping of estate planning documents and provides an opportunity to inform the client as to additional steps the client should take, such as telling others where to locate the original documents. <u>See</u> Pa. Ethics Op. 01-300.

IV. Terminating the Custodial Relationship

Once a custodial relationship has been established, the safekeeping lawyer may question when and under what circumstances it is appropriate to dispose of original estate planning documents. Numerous state ethics opinions require a lawyer to retain and ensure the safekeeping of original estate planning documents *indefinitely*, absent a controlled return of the documents to the client or compliance with state law. See, e.g., Conn. Ethics Op. 98-23 (1998) (distinguishing between ordinary client files and original estate planning documents); N.Y.C. Ethics Op. 1999-5 (1999); Or. Ethics Op. 1991-60 (1991); Pa. Ethics Op. 01-300; Utah Ethics Op. 132 (1993).

Several state statutes and ethics opinions address how a lawyer may terminate the custodial relationship. For example, a lawyer who is retiring or whose firm is dissolving may notify the client and request instructions for the disposition of the original will. See N.Y.C. Ethics Op. 1999-5. If the lawyer is able to reach the client and the client requests the return of the original document, the lawyer must take adequate steps to verify that it reaches the client safely. See, e.g., Mass. Ethics Op. 76-7 (1976). In attempting to reach the client, the safekeeping lawyer must be vigilant to avoid revealing the contents of or the existence of a client's will to anyone outside the attorney-client relationship. See Va. Ethics Op. 378 (1980). Thus, the ability to properly notify a client and terminate the custodial relationship rests on two assumptions: (1) the safekeeping lawyer has current contact information for the client and (2) the safekeeping lawyer is confident that his communications will reach the client and only the client.

Perhaps in recognition of the difficulties of terminating the custodial relationship, several states have enacted statutes governing how and when a lawyer may terminate a custodial relationship. California enacted one of the more protective statutes in 2007. See Cal. Prob. Code §§ 700 *et seq*.; see also Cal. Ethics Op. 2007-173 (2007). California's Probate Code provides that a lawyer may generally terminate a deposit by: (1) personal delivery of the document to the client; (2) mailing the document to the client's last known address, by registered or certified mail with return receipt requested, and receiving a signed receipt; or (3) a method agreed on by the client and lawyer. See Cal. Prob. Code § 731.

In the case of a client's death, a California lawyer may terminate the deposit by personal delivery of the document to the client's personal representative (or by personal delivery of the document to the client's trustee if the document is a trust). Id. § 734(a), (c). If the lawyer does not have actual notice that a personal representative has been appointed for the client, the lawyer must (1) deliver the will to the Clerk of the Superior Court of the county in which the estate of the decedent may be administered and (2) mail a copy of the will to the person named in the will as the personal representative, if the person's whereabouts is known to the lawyer, or if not, to a person named in the will as a beneficiary, if the person's whereabouts is known to the lawyer. Id. §§ 734(b); 8200.

The California statute further provides that where a safekeeping lawyer has not received notice of a client's death, the lawyer may transfer original estate planning documents to another lawyer. In such an event, the transferring lawyer must first mail notice to reclaim the document to the client's last known address and wait 90 days for the client's response. Id. § 732(a). Additionally, if a lawyer is deceased, lacks legal capacity, or is no longer an active member of the State Bar, a deposit may be terminated by transferring the original document to the Clerk of the Superior Court of the county of the client's last known residence. Id. §§ 732(c); 735. In the event of a transfer to another lawyer or to the Court, the transferring lawyer (or the person transferring documents on behalf of the lawyer) must provide notice to the State Bar of California. See id. § 733. Despite these protective features for the safekeeping lawyer, California's statute does not apply to other safekeepers, such as banks, trust companies, or other financial institutions.

By comparison, Indiana's statute enacted in 2006 applies to any person in possession of an original will. See Ind. Code § 29-1-7-3.1; see also David A. Smith, "Filing Wills with the Circuit Court Clerk, Res Gestae (June 2006). The Indiana statute generally permits a person to deposit a will with the Clerk of the Circuit Court of the county in which the testator resided when the will was executed. The Indiana statute applies whether or not the testator is still living and permits any person, not just a safekeeping lawyer, to deposit the will with the Circuit Court. See Ind. Code § 29-1-7-3.1. Upon deposit, the will is placed in a sealed envelope and is deliverable only to the testator or to persons authorized by the testator in a signed writing. Id.

However, the Indiana statute only applies to wills, not other estate planning documents such as trusts, advance medical directives, or powers of attorney, and is of limited value. Further, the Circuit Court may collect a fee upon deposit. Notably, the Clerk must retain the will for 100 years after the date of deposit if no notice of death is received. If notice of death is received, the Clerk may deliver the will to the appropriate court having jurisdiction over the administration of the decedent's estate. Id.

Most states do not afford lawyers the luxury of a statutory regime like California's and Indiana's probate codes. Absent such a statute, upon retirement or dissolution, the safekeeping lawyer should index the original estate planning documents of missing clients and place them in storage or turn them over to a successor lawyer who is assuming control of the lawyer's firm or active files. See Assoc. of Bar of City of New York, 55 The Record 42 (2000); ABA Formal Opinion 92-369 (1992). Again, the safekeeping lawyer must proceed cautiously to preserve the confidences and secrets of the testator client.

Conclusion

In light of the duties discussed above, a drafting lawyer should carefully consider the custodial services of original estate planning documents offered to clients. The lawyer may wish to discuss the nature and extent of this service with clients and provide for a method of terminating the custodial relationship. As law firm vaults continue to be filled with original estate planning documents, it is likely that other states will enact protective statutes addressing when and under what circumstances a safekeeping lawyer may dispose of original estate planning documents. In any event, the safekeeping lawyer should become familiar with the affirmative laws in his or her state and the legal ethics opinions governing document retention. Because the statutes and ethics opinions discussed deal with lawyers and not financial institutions, these institutions should consider adopting "best practice" policies akin to the rules applicable to lawyers in their respective states, as their conduct is likely to be measured by the rules applicable to the safekeeping lawyer.

Charitable Strategies for Trust Beneficiaries

This *Trust Topics* presents the benefits of making distributions of appreciated property for philanthropically-minded beneficiaries.

Certain trusts permit distributions to be made to trust beneficiaries at the discretion of the trustee. There are benefits to making these distributions in the form of appreciated property—also called a distribution in kind**.** A distribution in kind is a distribution of property (for example, shares of stock), rather than cash, from a trust. The technique of distributing appreciated property bears investigating for the potential advantages to trust beneficiaries and charitable organizations that receive gifts from trust distributions.

When a trustee distributes appreciated property to a beneficiary, the trustee can determine the capital gains treatment of the distribution. The trustee does this in accordance with an election granted under Section 643(e)(3) of the Internal Revenue Code, commonly referred to as the 643(e) election.

Trustee may elect to recognize a capital gain

A trustee may elect to treat a distribution in kind as if the distributed property had been sold to the beneficiary at its fair market value on the distribution date. If that election is made, a capital gain is generated equal to the difference between the adjusted cost basis of the property and the fair market value of the property. (Adjusted cost basis is the original value of an asset adjusted for, among other things, mergers, stock splits and reinvested dividends.) That capital gain is taxable at the trust level. The beneficiary's cost basis in the property will be the fair market value of the property distributed. Such an election would not typically be made unless the trust had offsetting losses.

Trustee may decide not to recognize a capital gain

If a trustee distributes appreciated property and does not elect to recognize a capital gain, no gain is recognized by the trust. The beneficiary's cost basis in the property remains the adjusted cost basis of the trustee (not the fair market value). The beneficiary would, therefore, realize a capital gain upon the sale of the assets.

If, instead of selling the property and recognizing a capital gain, the beneficiary contributes the appreciated property to charity, everyone may benefit. Scenarios One and Two outline this strategy.

Scenario one: When the trustee has the discretion to distribute both income and principal

Consider a trust in which the trustee has the discretion to pay income and principal to the beneficiary. Assume the trust has received dividend and interest income of $50,000 for the year. The trustee decides to distribute securities from the principal of the trust (a distribution in kind) and not the dividend and interest income.

For example, assume the trustee chooses to distribute ABC stock purchased in 1970 that now has a fair market value of $50,000 and an adjusted cost basis of $10,000. The stock distribution is made to a trust beneficiary.

The trustee in this scenario does not elect to recognize a capital gain, which means that the trustee's adjusted cost basis is passed on to the beneficiary. In other words, no gain is recognized on the distribution to the beneficiary; it is capital gains tax neutral.

The beneficiary, in turn, chooses to contribute the distributed property to a charitable organization.

Scenario one: Win-win tax result

- The amount of ordinary income the beneficiary has to report is limited to $10,000. That is, the ordinary income reportable by the beneficiary is only the value of the adjusted cost basis of the securities, not the $50,000 fair market value of the securities;

- Further, the beneficiary is able to claim a charitable income tax deduction of $50,000 when the charitable gift is made (subject to certain limitations based on the beneficiary's overall income); and

- No capital gain is recognized by either the beneficiary or the trust. In addition, the charitable organization can sell the securities at any time without incurring capital gains taxes. Thus, no capital gains taxes need to be paid by any of the three parties: trust, beneficiary or charity.

As is the case with individuals, trusts are responsible for paying taxes on dividend and interest income earned during the year. However, to the extent a distribution is made to a trust beneficiary, the trust is entitled to a distribution deduction to offset income.

In this scenario, the trust is entitled to a deduction equal to the value of the adjusted cost basis of the securities distributed. Thus, the trust would potentially be liable for taxes on only $40,000 of dividend and interest income (the $50,000 of dividend and interest income earned by the trust, less the $10,000 distribution deduction).

The trust must still pay taxes on $40,000 of income earned for the year, but the trustee has the benefit of being able to reinvest the net income after taxes in any manner the trustee likes. If all the income was distributed to the beneficiaries, the trustee might be forced to sell some existing trust holdings to raise the cash to make a new investment. And that sale might have capital gains tax consequences of its own.

The trustee has, in effect, diversified a low basis stock position without incurring any capital gains taxes. In accordance with the Prudent Investor Rule, which is the law governing the investment of trust assets in most states, a trustee must diversify trust assets, unless the trustee determines that it is in the interest of the beneficiary not to diversify. Accordingly, for trusts with a large block of low-basis stock, the strategy bears consideration as part of a tax-efficient diversification program.

In addition, the beneficiary has made a contribution of appreciated securities to a charitable organization without generating any capital gains for a charitable deduction equal to the *fair market value* of the securities.

Scenario two: When the trustee is required to distribute income and has the discretion to distribute principal

Consider use of this strategy for a trust that requires all of its income to be paid to the beneficiary, and the trustee, in the trustee's discretion, can make principal payments to the beneficiary.

Assume the trust has dividend and interest income of $50,000 for the year, and the trustee is required to distribute that $50,000 to the beneficiary. In addition, as a principal distribution, the trustee chooses to distribute securities with a fair market value of $50,000 and an adjusted cost basis of $10,000 to the beneficiary. The trustee does not elect to recognize a capital gain. The beneficiary contributes the distributed property to a charitable organization.

Scenario two: Win-win tax result

- The amount of ordinary income the beneficiary has to report is limited to $50,000 (the amount of the dividend and interest income distributed). The distribution of the securities with a fair market value of $50,000 is in effect a tax-free distribution of principal (assuming any capital gains taxes payable as a result of the sale of other trust assets during the course of the year are paid by the trust);

- Further, the beneficiary can claim a charitable income tax deduction of $50,000 when the charitable gift is made (subject to certain limitations based on the beneficiary's overall income); and

- No capital gain is recognized by either the beneficiary or the trust, and the charity can sell the securities without the imposition of capital gains taxes. Again, no capital gains taxes need to be paid by any of the three parties: trust, beneficiary or charity.

From the trustee's standpoint, since the trust is required to distribute all of its income, no income tax is payable by the trust on that income, and no capital gain is recognized on the principal distribution.

Trustee's discretion is key

For philanthropically-minded trust beneficiaries, the benefits of distributing appreciated property in kind for all involved can be very attractive. However, for the strategy to work in either scenario, a distribution in kind must be made at the trustee's *discretion* from either income or principal. A distribution in kind would not result in the same benefits if, for example, the distribution to the beneficiary is made in satisfaction of an obligation to distribute a fixed amount. In that case, a capital gain will be recognized at the trust level, and a capital gains tax will be payable by the trustee. The trustee would not be able to distribute low-basis securities to the beneficiary without capital gains tax consequences.

If the trustee has discretion, the technique of distributing appreciated property in kind is well worth exploring.

About the authors:
Sharon L. Klein, Senior Vice President, Trust Counsel and Director of Estate Advisement, has over 17 years' experience in the area of trusts and estates and is a frequent speaker and author on estate and trust planning, administration and management issues. Prior to joining Fiduciary Trust, Ms. Klein was Special Counsel in the trusts and estates department at Rosenman & Colin LLP (now Katten Muchin Rosenman). Previously, she served as law clerk to the Hon. Chief Judge Fox of the Federal Court of Australia. Ms. Klein received B.A. and LL.B. degrees from the University of New South Wales, Sydney, Australia, and an LL.M. from the Boalt Hall School of Law at the University

of California, Berkeley.

Henry S. Ziegler, Esq. is a graduate of Harvard College and Columbia Law School. He was formerly a senior vice president and special advisor for global estate planning at Fiduciary Trust Company International. In addition he was a partner of Shearman & Sterling, where he headed up the individual clients practice group, which represented clients in trust and estate, tax and related matters. In addition, Mr. Ziegler was chairman and CEO of Deutsche Bank Trust Company.

Fiduciary
Trust
International

NEW VOLUNTARY DISCLOSURE PROCEDURE
FOR OFFSHORE ACCOUNTS

Gideon Rothschild
Moses & Singer LLP

Amidst the UBS investigation of offshore bank accounts, the Internal Revenue Service announced, in a memo dated March 23, a new guideline to encourage US taxpayers to come clean on their offshore accounts without the risk of criminal prosecution and significantly increased penalties.

Although there has been a voluntary compliance program in place for many years on an informal basis, many taxpayers have been reluctant to come forward for fear that the penalties can exceed the amounts in the offshore accounts. The new program sets forth maximum civil penalties and an agreement not to criminally prosecute. It is to be administered centrally in the Philadelphia service center to ensure uniformity in the assessment of tax and penalties. Taxpayers who wish to avail themselves of this offer must come forward prior to September 23, 2009. Commissioner Shulman said that “[F]or taxpayers who continue to hide their head in the sand, the situation will only become more dire”, including potential criminal prosecution.

Taxpayers may avail themselves of the reduced penalties provided they are not yet subjects of a criminal investigation and cooperate fully with the IRS. It is not clear to what extent such cooperation will be a prerequisite to accepting the reduced penalties. This writer believes that all details regarding the source of the funds, how the taxpayer opened the account and whether there were other professionals involved in the establishment of the account or any company or trust formations will be required to be disclosed.

Voluntary disclosure requests will be resolved under the following framework::

1. The taxpayer must file amended returns including Form TDF 90-22.1 (Foreign Bank Account Return (FBAR)) and informational returns (i.e. Form 3520 or 5471) for the preceding six years (unless the account(s) were opened less than six years ago, then for such number of years they existed)
2. The payment of tax and interest for the six years plus a payment of the accuracy related penalty of 20% or a 25% penalty for failure to timely file. Reasonable cause will not be accepted as a defense to such penalties.
3. The payment of a 20% penalty on the highest balance in the offshore account during such six year period. This penalty may be reduced to 5% if the taxpayer did not open or create the foreign account (e.g., it was inherited), has never withdrawn funds from the account or added funds thereto and all US taxes were previously paid on the funds deposited in the account.

A taxpayer who wishes to come clean will proceed through the Criminal Investigation Division which will then process the returns in accordance with the IRM Section 9.5.11.9.(http://www.irs.gov/irm/part9/ch05s13.html) If the taxpayer meets all the requirements, the returns will then be forwarded to the Philadelphia Offshore Identification Unit (POIU) for examination, which will then issue a closing letter.

Prior to this announcement, taxpayers had the option of making a formal voluntary compliance offer through the CID (often referred to as a "noisy filing") or simply filing the amended returns in the mail (a "stealth filing"). The unknown factor up until now in either case has been how the FBAR penalties will be assessed. These penalties were recently increased to the greater of $100,000 or 50% of the highest balance in the account for each year of nonfiling. The current initiative will resolve this uncertainty in favor of a one time 20% penalty. Taxpayers who file under this initiative will also avoid numerous other potential penalties and possible criminal prosecution. It is this author's view that taxpayers with unreported offshore income should RUN, not walk, to their tax attorney and seek to resolve their delinquency prior to the six month deadline.

Further information can be found at:
http://www.irs.gov/newsroom/article/0,,id=206012,00.html

Recent Valuation Case Summaries

By John H. Hardwick, Jr., Esq.
Management Planning, Inc.

Litchfield v. IRS, T.C. Memo. 2009-21. Filed January 29, 2009.

The decedent was a minority shareholder in two family holding companies formed in the 1920s, one (LRC) with Iowa farmland and marketable securities and the other (LSC) with marketable securities. Both companies were incorporated as C corps and had unrealized capital gains tax liability on the potential sale of substantially appreciated assets.

Valuation experts for the estate and IRS deducted discounts for built-in capital gains taxes, lack of control (minority interest) and lack of marketability, as follows:

	LRC		**LSC**	
	Estate	*IRS*	*Estate*	*IRS*
Capital Gains Taxes	17.4%	2.0%	23.6%	8.0%
Lack of Control	14.8%	10.0%	11.9%	5.0%
Lack of Marketability	36.0%	18.0%	29.7%	10.0%

The Court agreed with the estate on capital gains taxes and lack of control but reduced its lack of marketability discounts to 25% (LRC) and 20% (LSC).

There are a few factors considered in Judge Swift's opinion that deserve mention:

✓Unlike recent Circuit Court decisions in *Dunn* and *Jelke*, there was no assumption of immediate liquidation of underlying assets on the valuation date in calculating potential capital gains taxes. The estate's expert considered the history of asset sales and plans for future sales and then projected holding periods and sale dates, estimated future appreciation, calculated taxes and, finally, reduced the taxes to present value. The IRS expert failed to consider future appreciation in determining present value.

✓Both experts used public guidelines (closed-end funds for marketable securities and REITs and RELPs for farmland) to support their discounts for lack of control. However, the IRS expert's discount for LRC was improperly weighted so as not to reflect the fact that farmland represented two-thirds of net asset value.

✓Relative "investor rights" in LRC and LSC were measured by the estate's expert as part of his discount for lack of control analysis. For example, the inability of a minority investor to do much about LRC's low historical returns (only 1% for farmland) helped support a larger discount for LRC than for LSC.

✓The Court’s explanation for reducing the discounts for lack of marketability was brief. It said the discounts were “too high” when combined with discounts for lack of control. It also noted that the estate’s expert had used a lower discount in a previous gift tax return and had relied upon “outdated data” for restricted stock discounts.

COMMENT: In the context of the lack of marketability of an interest in a closely held family business, older restricted stock studies reflecting longer Rule 144 holding periods are actually more relevant than more recent studies with shorter holding periods.

Gross v. Commissioner, T.C. Memo. 2008-221. Filed September 29, 2008.

After discussions and agreement with her two daughters about the need for a family limited partnership for investment management purposes, Bianca Gross filed a certificate of limited partnership with the State of New York on July 15, 1998. Transfers of marketable securities and nominal cash to a partnership account over the next few months were completed by December 4, 1998. On December 15, 1998 Ms. Gross and her daughters signed the partnership agreement and Ms. Gross made 22.25% gifts of limited partnership interests to each daughter. A 35% combined valuation discount was applied in valuing the gifts.

The IRS argued that indirect gifts of marketable securities had been made because the partnership was not formed until the agreement was signed, which was after the transfers.

Judge Halpern ruled in favor of Ms. Gross. The filing of a certificate of limited partnership is conclusive evidence of the formation of the partnership under New York law. Furthermore, New York law permits formation of a general partnership where limited partnership formation requirements fail if the conduct of the parties suggests a partnership arrangement. The Judge reviewed the facts and found nothing inconsistent with a limited or general partnership’s formation on July 15.

COMMENT: MPI was valuation expert for Ms. Gross. Our combined discount was approximately 41%. A combined discount of 35% was stipulated by the IRS and Ms. Gross.

Holman v. Commissioner, 130 T.C. No. 12. Filed May 28, 2008.

In a reviewed opinion in a case involving gifts of limited partnership interests within a few days after the partnership was formed and funded, the Tax Court rejected IRS “indirect gift” and “step transaction” arguments but said transfer restrictions in the partnership agreement should be ignored for valuation purposes, relying on Code Section 2703. In doing so, we believe the Court did not follow hypothetical willing buyer-willing seller standard precedent (see *Morrissey* and *Simplot* cases) when it speculated that a partner who wanted out would be accommodated. We understand many in the legal community view this as reversible error. In fact, the taxpayer has appealed.

MPI was the taxpayer's valuation expert. Our combined valuation discount of 44% (14% minority interest and 35% lack of marketability) for the 1999 gifts was reduced to 22% (11% and 12.5%).

Under Section 2703 a restriction on transfer is disregarded unless (1) it is a bona fide business arrangement, (2) it is not a device to transfer property to the family for less than adequate consideration and (3) its terms are comparable to similar arrangements between persons in an arm's length transaction. The Court did not rule on the third requirement because it decided the transfer restrictions in the partnership agreement failed to meet the first two. It saw no "bona fide business purpose" where the primary reason for the partnership was preservation of family wealth. As for the second requirement's "device" test, the Court stated:

> "….given the significant minority interest and marketability discounts from an LP unit's proportional share of the partnership's NAV that each expert would apply in valuing the gifts, it would appear to be in the economic interest of both any limited partner not under the economic necessity to do so but wishing to make an impermissible assignment of LP units and the remaining partners to strike a deal at some price between the discounted value of the unit and the dollar value of the units' proportional share of the partnership's NAV. The wishing-to-assign partner would get more than she would get in the admittedly "thin" market for private transactions, and the dollar value of each remaining partner's share of the partnership's NAV would increase."

COMMENT: There is considerable discussion in the opinion about the discount for lack of marketability, its components and restricted stock studies, but the bottom line is the application of Section 2703 and its huge impact on the Court's valuation conclusions. Indeed, even the IRS appraiser was at a 35% combined discount (11% and 27%) if the restrictions were taken into account.

<u>Astleford v. Commissioner</u>, T.C. Memo. 2008-128. Filed May 5, 2008.

This gift tax case involved the valuation of limited partnership interests in a family real estate partnership, one of the assets of which was a 50% general partnership interest in a partnership owning Minnesota farmland. The 50% interest was noncontrolling since each 50% general partner could not act alone.

The IRS has often argued that valuation discounts at levels below the top tier or "parent" entity are not appropriate. Here the Court allowed lack of control and marketability discounts at both levels, noting that the farmland partnership was only 16% of overall net asset value and one of fifteen real estate investments. Concluded combined discounts were 30% for the general partnership interest and roughly 35% for the limited partnership interest.

COMMENT: Judge Swift's list of favorable multi-tiered discount Tax Court cases is handy:

> *Estate of Piper v. Comm'r.*, 72 T.C. 1062 (1979).

Janda v. Comm'r., T.C. Memo. 2001-24.
Gow v. Comm'r., T.C. Memo. 2000-93, affd. 19 Fed. Appx. 90 (4th Cir. 2001).
Gallum v. Comm'r., T.C. Memo. 1974-284.

Estate of Mirowski v. Commissioner, T.C. Memo. 2008-74. Filed March 26, 2008.

Anna Mirowski formed and funded a Maryland LLC with 90% of her assets, made gifts of 16% noncontrolling interests to her three daughters' trusts, keeping a 52% majority interest as general manager, and then died. All of this occurred over a two week period. Are these facts bad enough for Code Sections 2036 and 2038 to apply? Here are some of the reasons why Judge Chiechi rejected IRS arguments that the LLC's assets should be added back to the gross estate:

- Mrs. Mirowski's eight month illness was treatable and her death was unexpected. The entire process of finalizing LLC arrangements took a little over a year.

- Among the "legitimate and significant" nontax purposes for creating the LLC were joint management of family assets, single pooling of assets to allow for more investment opportunities, and enabling children and eventually grandchildren to share family assets equally.

- Mrs. Mirowski retained sufficient assets ($7.5 million) to live on after her transfers to the LLC. An $11.8 million gift tax bill would have been paid from a combination of several sources, including personal assets, future 52% LLC distributions, and /or borrowing against same.

- The LLC was found to be a "valid functioning business operation" that had to manage matters relating to patents and a license agreement for an implantable defibrillator (the "ICD", invented by Mrs. Mirowski's deceased husband) as well as a $62 million securities portfolio.

- IRS arguments under 2036(a)(1), 2036 (a)(2) and 2038(a)(1) (retention and control of enjoyment) failed because a close reading of the LLC agreement showed that Mrs. Mirowski did not really have the authority to decide timing and amounts of distributions despite her majority interest. Furthermore, Maryland law imposed upon her fiduciary duties to other LLC members.

Estate of Jorgensen, T.C. Memo. 2009-66

Section 2036 Applied to Creation of FLPs; Equitable Recoupment Allowed to Adjust for Prior Income Tax Overpayments in Light of Increase in Basis Attributable to Increased Gross Estate Value

April 2009

Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

Synopsis:

The Internal Revenue Service won another §2036 marketable securities FLP case. Some of the facts were not terrible — the decedent retained assets for her day-to-day living expenses. However, other facts were pretty bad — (1) there was no evidence of why one FLP was created but contemporaneous attorney correspondence referred only to estate tax savings as the reason for creating the second (and much larger) FLP, (2) the decedent had control of the FLPs' checkbooks even though she was not the general partner, and (3) she in fact wrote checks out of the partnership accounts for personal purposes (including for making annual exclusion cash gifts). Particularly notable aspects of the §2036 analysis include:

- This is yet another case where the court pointed to post-death payments of estate taxes as reflecting an implied agreement of retained enjoyment of partnership assets to trigger §2036;
- In rejecting the "bona fide" transfer defense, the court found "especially significant that the transactions were not at arm's length and that the partnerships held a largely untraded portfolio of marketable securities;" and
- In dictum, the court observed that §2036 applied even as to assets attributable to partnership interests that the decedent gave to her children and grandchildren more than three years prior to her death, reasoning that the decedent "retained the use, benefit, and enjoyment of the assets she transferred to the partnerships."

In addition, under the equitable recoupment doctrine, the Tax Court allowed an offset in the estate tax liability for the "overpayment" of income taxes, where a refund of the income tax was barred by limitations and where the prior income tax payments did not reflect the increased bases as a result of the increased value included in the decedent's estate under §2036.

The case is appealable to the Ninth Circuit Court of Appeals.

Basic Facts:

1. In mid 1995, Mr. and Mrs. Jorgensen ("H and W") contributed about $450,000 (equally from each) of their $2 million portfolio of marketable securities to an FLP (JMA-I). H and the son and daughter of H and W were general partners, but H made all decisions regarding the formation and operation of the FLP. (There was no testimony as to why JMA-I was created; W's estate later argued "that tax savings could not have been the primary factor in forming the partnerships because discounts were not used in valuing Colonel and Ms. Jorgenson's gifts of partnership interests in 1995 through 1998." However, the court noted that discounts were claimed in H's estate after his death.)
2. H died in late 1996. JMA-I was valued with a 35% discount, and H's bypass trust was funded with an interest in the partnership.
3. In late January 1997, while administering H's estate, the estate planning attorney recommended in a letter that W transfer her brokerage accounts to JMA-I, to qualify for the valuation discount and to facilitate making annual gifts, saying "[t]his is important if you wish to reduce the amount of your own estate, which will be subject to estate taxes." The attorney wrote another letter to W the following day, again recommending that she transfer the brokerage accounts of her and H's estate to JMA-I to qualify for the 35% discount, which would result in estate tax savings of $338,487.50, concluding that "there can be no discount if the securities owned by you continue to be held directly by you."

4. The attorney subsequently had discussions with the son, the daughter and her husband (but not W), and the decision was made to form a new FLP (JMA-II). A letter from the attorney to W in May 1997, said that the purpose of creating a new partnership was to have the new partnership own high basis assets, while JMA-I would hold low basis assets, and W could make future gifts from JMA-II (which would hold high basis assets).

5. JMA-II was formed in July 1997. W contributed about $2.1 million of her marketable securities (including assets bequeathed to her from H's estate), and about $500,000 of marketable securities from H's estate. W received about an 80%, and H's estate held about a 20% interest in the new partnership. The two children were general partners. The children and grandchildren (and the son-in-law) were listed as limited partners in the partnership agreement, but they did not contribute anything.

6. In 1995, 1996, and 1998, W gave about 30.6% of JMA-I to her children and grandchildren collectively. In 1997 and 1998, she gave about 6.0% of JMA-II to her children and grandchildren. (Footnote 4). [Observe: These gifts ended up being made more than three years prior to W's subsequent death; she also made gifts in 1999, but the facts stated in the opinion do not indicate whether the 1999 gifts were more than three years prior to her death.]

7. In 1999-2002, W gave 34.75% of JMA-II to her children and grandchildren collectively. (Discounts of 50% and 42% were applied in valuing some of the gifts. Gift tax returns were filed for 1999 and later years, but not earlier years.).

8. In 1998, W consulted with a different estate planning attorney about making gifts to utilize her lifetime gift exemption. In October 1998, the attorney sent W a letter observing the possibility of an audit of such a large gift "because JMA-II held only passive investments." The letter went on to state that W "had several nontax reasons for creating JMA-II, including: The ability to transfer assets without disrupting the recipient's initiative, cost savings from the pooling of assets, simplification of gift-giving, protection against creditors, protection in the case of divorce, and the education of younger family members." The court gave little weight to this letter, observing that it "was written well after the formation and funding of the partnerships by an attorney preparing for potential litigation with respect to the gift." In a footnote, the court observed that the Tax Court has previously recognized "that taxpayers often disguise tax-avoidance motives with a rote recitation of nontax purposes" (citing Hurford and Bongard).

9. Even though W was not a general partner, she was authorized to write checks on the partnership accounts. In October 1998, she wrote checks on JMA-I of over $30,000, primarily for making cash gifts. In late January 1999, W wrote a $48,500 check to her daughter from JMA-I to equalize a gift she had previously made to her son (she did not have enough cash in her personal account to make the cash gift to her daughter). (In April 1999, W deposited $30,000 plus $48,500 in the JMA-II account to "repay" the amounts she had withdrawn from JMA-I to make cash gifts, without explaining why the deposit was made to the "wrong" partnership account; there was no "indication that the error was corrected.")

10. In July 1999, the son borrowed $125,000 from JMA-II to buy a home. He did not make any payments on the loan for several years, and then just made several interest payments.

11. W also paid her 1998 estimated quarterly income tax payments of about $9000 from JMA-I. She paid about $6500 of H's estate administration expenses from JMA-II, but she later repaid that amount. W also paid H's estate income tax and various administration expenses and expenses regarding her gift tax returns, and some of her attorney's expenses from JMA-II (and those amounts were not repaid).

12. W died on April 25, 2002.

13. At the attorney's recommendation, the son repaid his $125,000 loan from JMA-II in January 2003. Also in January 2003, JMA-II paid $211,000 for W's federal and California estate tax liabilities.

14. In 2003-2006, the partnerships sold various assets that W had contributed to them. To compute the gain, the partnerships used W's "original cost basis in the assets, as opposed to a step-up in basis equal to the fair market value of the assets on Ms. Jorgensen's date of death under section 1014(a)." The partners reported the gain and paid the related income taxes. In 2008, the partners filed protective claims for refund of the income taxes, but the refund claim for the 2003 income tax payment was not timely.

Holdings

1. Section 2036(a)(1) Applied. All of the assets in JMA-I and JMA-II attributable to W's original ownership interests were included in her estate. The bona fide sale exception did not apply, and the court found an implied agreement of retained enjoyment in the partnership assets, even as to assets attributable to gifts of limited partnership interests made more than three years prior to her death (in dictum, reasoning that she retained enjoyment of all assets she had transferred to the partnerships).

2. Section 2038. The government also argued that §2038 applied. The court did not summarize the government's argument and refused to address the §2038 issue in light of the fact that the assets were included in the estate under §2036(a)(1).

3. Equitable Recoupment. An offset in the amount of additional estate tax due was allowed for the "overpayment" of income taxes, where the prior income tax payments did not reflect the increased basis as a result of the increased value included in the decedent's estate under §2036.

Court's Analysis

1. Burden of Proof. The court did not decide whether the burden of proof shifted to the government, because its resolution was based on a preponderance of the evidence rather than on whether either party met its burden of proof.

2. Section 2036 Overview. Section 2036 requires three elements: (1) an inter vivos transfer, (2) that was not a bona fide sale for full consideration, and (3) in which the decedent retained an interest or right described in §2036(a)(1) or (2) or (b). The transfer requirement is satisfied by W's voluntary contributions to the partnerships. The balance of the §2036 analysis addressed the last two elements.

3. Bona Fide Sale Exception Not Applicable.

   a. Purported Nontax Reasons Not Recognized. The court did not view any of the nontax reasons stated in the after-the-fact letter by the estate planning attorney as being "legitimate and significant nontax reasons." (The letter is quoted in Item 8 of the Basic Facts section of this summary.)

      - Management Succession. Prior cases (Kimbell and Mirowski) that recognized efficient management as a nontax reason involved assets requiring active management, unlike this portfolio of marketable securities in which there was very little trading after H's death. Also, the FLPs were not needed to manage assets for W's benefit because her revocable trust and power of attorney could have been used to provide management of her assets.

- Financial Education of Family and Promoting Family Unity. H made all decisions during his lifetime and did not teach his children about investing. The failure to involve his children suggests that promoting family unity was not "anything more than a theoretical purpose." In fact, the partnerships could cause family disunity between the son and daughter because of their different spending habits (the son was a spendthrift and the daughter was frugal).
- Perpetuate Investment Philosophy and Motivate Participation. The Schutt case, which recognized implementing a "buy and hold" investment philosophy as a legitimate nontax reason, was distinguished because that case (involving the duPont family) addressed retaining "stock traditionally held by the family" including stock held in trust after those trusts terminated. (Footnote 10). The "motivating participation" reason is unconvincing because H did not include the children in decisions and limited partners are precluded from participating in decision-making.
- Pooling of Assets. As to pooling for W's benefit: W had no involvement in managing the assets or in the decision to transfer assets to JMA-I, so pooling was not a significant purpose of JMA-I. There is no credible evidence that W wished to pool her assets in JMA-II.

  As to pooling for the benefit of children and grandchildren: There is little evidence that economies of scale or better service followed from pooling of assets. The children and grandchildren would have received the same attention from the investment advisor by just linking their accounts.
- Creditor Protection. Taxpayers asserted spendthrift concerns, particularly about possible divorces, unwise spending by minors, and the son's free spending habits. However, the son was the general partner and he accessed partnership assets by a loan. Like other prior cases that have rejected the creditor protection reason, the court emphasized that there were not any particular creditor problems, and this was just a theoretical concern.
- Providing for Children Equally and Facilitating Gift-Giving. Facilitating and simplifying gift-giving is not recognized as a significant and legitimate nontax reason (citing Bongard and Bigelow).

b. Factors Indicating Not Bona Fide. The court emphasized several reasons suggesting that the primary purpose of the partnerships was saving taxes.

- Contemporaneous Advice Referred to Tax Savings. Advice given at the time the partnerships were formed all pointed to tax savings is the reason. A letter offering purported nontax reasons over a year later was given little weight.
- Disregard of Partnership Formalities. No books and records were maintained. There were no formal meetings of partners and minutes were never kept. W and her children often failed to respect the partnerships, paying personal expenses and mingling personal funds with partnership funds. Financial dependence on the partnership for making cash gifts and various non-pro rata distributions are further evidence of the disregard of formalities.
- No Arms Length Transfers. "When a taxpayer stands on both sides of a transaction, we have concluded that there is no arm's length bargaining and thus the bona fide transfer exception does not apply." (Citing the Strangi and Harper Tax Court cases.)

JMA-I: H made all decisions regarding JMA-I, so transfers of assets to it were not made at arm's length.

JMA-II: W funded JMA-II through her revocable trust and as executrix of H's estate, and the decision was made largely by her children. "Considering that Ms. Jorgensen stood on both sides of the transaction, although in different roles, we conclude that the transfer of assets to JMA-I was not at arm's length."

- Conclusion. "We find *especially significant* that the transactions were not at arm's length and that the partnerships held a largely untraded portfolio of marketable securities." (emphasis added) [Observation: This is the first court case that applies this much importance to the "arm's length" factor.]

c. Full Consideration Conceded. The government did not repeat its argument from prior cases that there was not full consideration when the decedent received a limited partnership interest worth less than the value of assets that she contributed. [Observe: The government apparently is now conceding this issue (at least in Tax Court cases), and the court restated the proportionality test of Kimbell and Bongard.]

4. Section 2036(a)(1) Implied Agreement of Retained Enjoyment.

a. Decedent Retained Assets for Living Expenses. The court acknowledged that W "retained sufficient assets outside the partnership for her day-to-day expenses."

b. Partnership Assets for Personal Expenses (Primarily to Make Gifts). W wrote various checks on the partnerships for her personal expenses and for expenses of H's estate administration. The court pointed primarily to her need for cash from partnerships to make cash gifts. (The court did not specifically mention payments of the partners' income taxes in this portion of the opinion.)

c. Post-Death Payments from Partnership. The court highlighted post-death distributions of $179,000 and $32,000 used to pay transfer taxes, legal fees, and other estate obligations. "The use of a significant portion of partnership assets to discharge obligations of a taxpayer's estate is evidence of a retained interest in the assets transferred to the partnership" (citing the Rosen, Korby, and Thompson Tax Court cases and the Strangi Fifth Circuit Court of Appeals case). [Observe: For some reason, the court did not cite the Erickson case, which seems to point almost exclusively to post-death payments as creating the implied agreement of retained enjoyment under §2036(a)(1).]

d. Substantial Amount Distributed in Non Pro Rata Distributions. The "actual use of a substantial amount of partnership assets" to pay pre-death and post-death obligations supports the finding of an implied agreement of retained enjoyment. Furthermore, even charging such distributions against the decedent's share of the partnership would not have helped: "This is true regardless of whether the distributions were charged against her percentage interest in the partnerships, and especially relevant considering that under the terms of the partnership agreements all distributions were to be pro rata."

e. Fiduciary Duties to Decedent Further Evidence of Implied Agreement. The son and daughter were general partners of the partnerships and were also co-trustees of W's revocable trust. As co-trustees, they had the duty to administer the trust solely for W's benefit, and their investment of trust assets in the FLPs in light of this fiduciary duty to W is further evidence of an implied agreement of retained enjoyment by W of assets contributed to the FLPs.

5. <u>Section 2036 Applied Even As to Assets Attributable to Partnership Interests Given More Than Three Years Prior to Death</u>. In objecting to one of the government's proposed finding of facts, the estate stated that if §2036 applied, it should only apply to assets that W held on the date of her death plus transfers made within three years. The court concluded (in footnote 13) that the estate waived or abandoned any claim that assets attributable to gifts of partnership interests made more than three years prior to her death should not be included under §2036 by failing to argue the issue beyond a vague assertion within an objection to a proposed finding of fact. In dictum, the court stated that even if the issue had not been waived, "we would not find that Ms. Jorgensen terminated a portion of her interest in the partnership assets. The record indicates that Ms. Jorgenson retained the use, benefit, and enjoyment of the assets she transferred to the partnerships." [Observe: The court reached that conclusion even though the decedent apparently never made payments from the partnership that exceeded her pro rata value of partnership assets. From a planner's perspective, this dictum may be the scariest aspect of this case, suggesting that assets attributable to partnership interests transferred long before the decedent's death could be brought back into the estate under §2036(a)(1) by finding an implied agreement of being able to access all partnership assets, even those attributable to interests that had been sold or given to other individuals.]

6. <u>Equitable Recoupment</u>. An amendment in 2006 to §6214(b) allows the Tax Court to apply the doctrine of equitable recoupment. The court analyzed the four elements of the equitable recoupment doctrine: "(1) The overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the transaction, item, or taxable event has been inconsistently subjected to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one."

   a. <u>Overpayment Barred by the Statute of Limitations</u>. A refund of the income taxes for 2003 was barred by the statute of limitations, so the doctrine can apply with respect to the overpayment of income taxes in 2003.

   b. <u>Overpayment Arose Out of A Single Transaction</u>. This requirement was met because the same item that was included in the gross estate was the item that was sold and generated the gain that produced the income tax overpayment.

   c. <u>Subject to Two Taxes Inconsistently</u>. The court reasoned that the increased basis as a result of including additional value in the decedent's gross estate should result in decreased gain recognition. [Observe: The taxpayer may have been fortunate as to this element. The opinion indicated that the amount of the taxable gain in 2003 was computed based upon W's original basis rather than on a stepped-up basis under §1014. Based on the reporting position taken (i.e., not computing gain based on a stepped up basis under §1014), the amount of the 2003 income tax arguably is not inconsistent with an increase in the gross estate value. Furthermore, the facts do not make clear whether a §754 election was in effect for the partnerships; if not, there would not have been an increase in the "inside basis" of the partnership assets by reason of the death of a partner.]

   d. <u>Sufficient Identity of Interest</u>. The court reasoned that it does not matter that the grandchildren, who also paid some of the increased income tax, are not liable for the estate tax attributable to inclusion of additional value under §2036. "[T]he relevant caselaw does not indicate that the taxpayer who overpaid tax must be the one responsible for the related deficiency for equitable recruitment to apply."

e. Conclusion. "It would be inequitable for the assets to be included in the value of Ms. Jorgensen's gross estate under section 2036 on the one hand, and on the other hand for the estate not to recoup the income taxes her children and grandchildren overpaid on their sale of those very same assets but are unable to recover in a refund suit." The court allowed the recoupment of the overpayment of 2003 income taxes attributable to additional basis step-up allowed under §1014 because of the §2036 inclusion of partnership assets in the gross estate.

Observations

1. Cannot Avoid §2036 By Merely Retaining Assets for Living Expenses. Planners should not fall into the trap of thinking that by merely having a client retain sufficient assets for living expenses that §2036 (a) (1) can necessarily be avoided.

2. Non Pro Rata Distributions to Pay Decedent's Personal Expenses. The key item evidencing an implied agreement of retained enjoyment in this situation was the actual payment of personal expenses of the decedent (primarily to make cash gifts and also to pay post-death expenses) in a non-pro rata manner.

3. Post-Death Payments of Estate Taxes and Administration Expenses. The court pointed very explicitly to the payment of estate taxes and other administration expenses as evidencing an implied agreement of retained enjoyment. It would seem that the use of partnership assets after death is irrelevant as to the retained right to enjoy assets under §2036 "for life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death." However, there is a growing number of cases that have now looked at post-death partnership payments to trigger §2036(a)(1). The court quoted the Fifth Circuit's statement that "part of the 'possession or enjoyment' of one's assets is the assurance that they will be available to pay various debts and expenses upon one's death." Strangi, 417 F.3d at 477.

   Interestingly, the court did not cite the Erickson case, in which the only distributions from the partnership for the benefit of the decedent were the post-death payment of taxes. T.C. Memo. 2007-107. In Erickson, the court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Ericsson (or the estate) could use the assets if needed."

   What if there are non-liquid assets in the estate and insufficient liquid assets for paying all post-death expenses? John Porter's recommendations (from presentations at various seminars):

   (a) It is best is to borrow from a third party, but a bank may be unwilling to do that using only the partnership interest as collateral.

   (b) Borrow from an insurance trust or a family entity, secured by the partnership interest.

   (c) There are three options for utilizing partnership funds: redemption, distribution or loan. Erickson involved a purchase of assets and redemption but the court still held against the taxpayer. Pro rata distributions are a possibility, but if they are made on an "as needed basis" that plays into IRS's hands on the §2036 issue; the estate can argue that distribution for taxes are made all the time from partnerships, but usually income taxes. If the partnership assets must be used directly to pay taxes, John prefers borrowing from the partnership on a bona fide loan, using the partnership interest as collateral. It is best to use a commercial rate rather than the AFR rate (that looks better to the government as an arm's length transaction). Also, consider using a Graegin loan — with a fixed term and a prohibition on prepayment. The IRS is looking at Graegin loans in FLP audits, but John has used them successfully in a number of cases.

[Some attorneys suggest that the preferred approach is to have other family members or family entities purchase some of the decedent's partnership interest to generate cash flow to the estate for paying post-death expenses. The partnership assets would not be utilized at all under that scenario.]

4. Actual Operation of Partnership Critical in Reviewing Nontax Reasons. Despite the fact that the nontax reasons for creating the partnership was described in a letter written more than a year after the partnerships were created, the court focused primarily on the fact that the actual operation of the partnerships was not consistent with the purported nontax reasons.

5. Partnership Interests Transferred More Than Three Years Before Decedent's Death. If an individual relinquishes within three years of death an interest or power that would cause estate inclusion under the "string" statutes, the assets are still included in the gross estate under §2035. Conversely, if an interest or power that causes estate inclusion under the string statutes is relinquished more than three years before death, §2035 does not apply. It is understandable that if a decedent retains control over partnership assets that causes estate inclusion under §2036(a)(2) or 2038, the three-year rule should not come into play, because the decedent still actually has that degree of control at his or her death. However, it would seem that the answer would be different if §2036(a)(1) is being considered, because it depends on retained enjoyment of assets, and under state law a partner is not entitled to assets attributable to partnership interests that the decedent does not own. In fact, distributions of partnership assets that cannot be attributed to the decedent's interest in the partnership would be theft or an illegal diversion of property from the rightful owners. Nevertheless, a troublesome number of courts have now concluded that a decedent retained personal enjoyment of all partnership assets, even those attributable to interests that were transferred more than three years prior to the decedent's death. The court's analysis of this issue in Jorgensen is dictum; nevertheless, the court makes clear that it would have found that the decedent retained enjoyment of all partnership assets attributable to her original contributions, even though there were apparently never any distributions for the decedent's benefit in excess of her pro rata value of the partnership assets.

Other examples where the decedent was found to have retained personal enjoyment of the FLP assets even after limited partnership interests had been given away were the Estate of Korby and Estate of Rosen cases, Even though the gifts in the Korby cases may have been made more than three years before death, that apparently was irrelevant because the court found the existence of an implied agreement to retain enjoyment of all of the income of the partnership even after the limited partnership interests had been given away. 471 F.3d 848 (8th Cir. 2006). Similarly, the Rosen case held that all partnership assets were included even though the decedent had given away substantial partnership interests more than three years before her death. She was the only partner to receive cash flow from the partnership, and the court concluded very simply that §2035 was not relevant because "Decedent continued to possess and enjoy the transferred assts up until her death." T.C. Memo. 2006-115. See also Estate of Bigelow (all FLP assets included under

§2036 even though decedent made gifts of over 50% of the limited partnership interests by the time of his death).

The obvious planning implication is that following gifts of partnership interests, only proportionate distributions should be made, and nothing should be done to create any implication that the decedent will receive any distributions of partnership assets attributable to previously transferred partnership interests. Furthermore, in light of the inherent §2036(a)(1) uncertainty that can arise by mere implied agreement based on the court's interpretation of the facts, planners may want to consider advising clients who have successfully transferred substantial interests in an FLP to terminate the FLP to remove any possible taint of retained enjoyment of partnership assets that are attributable to transferred partnership interests. If the court would find the existence of a retained enjoyment in all partnership assets, the client would have to live three years after the partnership termination to avoid §2035, but at least the three period could begin running to close the books on the possible application of §2036 to the prior successful transfers. (Of course, the termination of the partnership would be inconsistent with the nontax purposes of the partnership; a reasonable reply would seem to be that the family hates giving up the nontax benefits of the FLP, but it is forced to do so because of the possible tax disadvantages of continuing the FLP.)

6. <u>Practical Planning Pointers From Jorgensen</u>.

   a. <u>Documentation of Nontax Purposes</u>. Correspondence or advice given contemporaneously with the creation of the partnership should refer to the nontax reasons for the partnership. Saving estate taxes should not be the overriding primary purpose for creating the partnership in order to avoid §2036. In <u>Jorgensen</u>, tax savings (and facilitating gift-giving to save taxes) were apparently the only reasons discussed when the partnerships were created. Under the statutory language of §2036, having nontax reasons should be unimportant if the decedent does not retain interests or powers that would trigger §2036(a)(1) or (2). However, so far, every court that has concluded that there were no legitimate nontax reasons has also managed to find some interest or power that would trigger §2036(a)(1)(or (a)(2).

      Furthermore, as discussed in Item 4 above of these "Observations," the court will scrutinize whether the partnership is actually operated in a way that implements those nontax reasons.

   b. <u>Avoid Non Pro Rata Distributions for Paying Personal Expenses</u>. The court concluded that that an implied agreement of retained enjoyment existed in large part because of the actual non pro rata payments from the partnerships for the decedent's personal uses. If possible, avoid making any distributions to avoid assisting the government in making an implied agreement of retained enjoyment argument. At the least, only make pro rata distributions, and make the distribution decisions based on factors relating to the partnership assets and not based on the personal needs of the partners.

   c. <u>Keeping Sufficient Assets to Pay Living Expenses Is Not a Safe Harbor Around §2036(a)(1)</u>. Do not assume that §2036(a)(1) can be ignored just because the client retains sufficient assets to pay his or her normal living expenses.

   d. <u>Control of Partnership Checkbook</u>. It looked extremely suspicious in <u>Jorgensen</u> that the decedent retained the enjoyment of partnership assets when she could (*and did*) write checks on the partnership account even though she was not a general partner.

   e. <u>Involve Others in Negotiations</u>. In light of the court's emphasis on the importance of arm's length transactions (<u>more than any other court so far</u>), planners may want to place more emphasis on having meaningful negotiations when partnerships are created. Consider having some third party partners at the outset who can enter into negotiations. If there are not other family members as partners from the outset, include family members who may receive interests in the future (by gift, sale, investment in the partnership, or bequest) in the negotiations. The parent may wish to pay for an attorney to represent the other partners to facilitate actual bargaining and negotiation. It would seem to be particularly helpful if meaningful revisions were made to the partnership structure or partnership investments in light of the negotiations.

f. Investment Changes. The court, in its final statement of what particularly troubled the court, pointed to the lack of negotiations and the fact that the partnership consisted of a "largely untraded portfolio of marketable securities." After the creation of the partnership, it is helpful if there are changes in the investment mix. If possible, the partnership might even considering purchasing assets other than marketable securities with a portion of its assets.

g. Satisfying Qualified Purchaser and Accredited Investor Rules. A very real concern of many wealthy families is that the parents have sufficient wealth to qualify as "qualified purchasers" (which generally requires that individuals have $5 million of net "investments" — not including the home or assets that are not held for investment) and "accredited investors" and are able to invest in unregistered securities, but their children may not. Pooling of assets in this situation, to allow the flexibility of future investments in such opportunities if they arise, is an important nontax reason for pooling investments in a partnership. That reason apparently did not exist in the Jorgensen situation, but if it applies in another family situation, highlight that nontax reason. (Consistent with the prior statements, it would be helpful if that reason gets implemented under the actual operation of the partnership if the opportunity arises for the partnership to invest in such an investment requiring qualified purchasers or accredited investors.)

h. Investment by Fiduciary of Revocable Trust. The court pointed out that investment in an FLP by a revocable trust for the decedent, where she had the right to access trust assets at any time, was one indication of an implied agreement that the partnership assets could be used for the decedent's benefit. This factor was more sensitive under the Jorgensen facts where the co-trustees of the revocable trust were also the general partners of the FLP.

i. Insulate Spendthrift From Distribution Decisions. If part of the reason for creating an FLP is because of creditor concerns for a particular partner who is a spendthrift, do not name that person as a general partner with authority over distributions.

k. File Protective Claims for Refund If Gain Recognized Attributable to Hard-To-Value Assets in an Estate. The Jorgensen family could have avoided having to make the equitable recoupment argument (which it may have been fortunate to win) if it had just filed a timely protective claim for refund with respect to income taxes paid with respect to the sale of partnership assets. Whenever taxable gain is recognized from the sale of assets that might possibly be subject to scrutiny (either inclusion or valuation) in an estate tax audit, the persons who pay the income tax should file a protective claim for refund in case the estate tax audit results in an increased value, which would therefore result in an increased basis. (For a partnership, this issue should only arise for a sale of partnership assets if the partnership has a §754 election in effect at the death of the relevant partner, which would then result in an increase of the "inside basis" of the partnership in the partnership assets.)

U.S. employers must begin using the revised U.S. Citizenship and Immigration Services (USCIS) Employment Eligibility Verification Form known as the I-9 (Form I-9) on April 3, 2009. Meanwhile, certain federal contractors and subcontractors also must prepare to comply with impending requirements to use USCIS E-Verify when hiring employees scheduled to take effect May 21, 2009.

New Form I-9

The use of the new Form I-9 is required under an interim rule published by USCIS in December 2008. The interim rule also changes the types of acceptable identity and employment authorization documents employers can accept from new hires and prohibits employees from using expired identification documents to verify their work eligibility beginning April 3, 2009. Employers will be required to use the new Form I-9 and to secure documentation of proof of eligibility to work in accordance with the revised rules contained in the interim rule for all new hires and to reverify any employee with expiring employment authorization in accordance with the interim regulations beginning on April 3, 2009.

Employers can download a copy of the new Form I-9 at http://www.uscis.gov/files/form/I-9_IFR_02-02-09.pdf. The interim regulations are available for review at http://edocket.access.gpo.gov/2008/E8-29874.htm. USCIS presently is updating the Handbook for Employers, Instructions for Completing the Form I-9 (M-274).

The new Form I-9 replaces the June 5, 2007 edition of the Form I-9 (the Old Form I-9), which will not be valid for use after April 2, 2009. A big change in the new Form I-9 requirements is that expired documents cannot be accepted as proof of eligibility to work. All documents presented during the Form I-9 completion process now must be unexpired. The new Form I-9 and interim regulations also add and remove certain documents to the list of documents that employers can accept of proof of identity and/or eligibility to work in the U.S.

The interim rule originally was scheduled to take effect on Feb. 2, 2009. The Obama Administration extended the effective date to April 3, 2009 under a directive issued in January.

Federal Contractor E-Verify Rule Scheduled To Take Effect May 21, 2009

Certain federal contractors and subcontractors also need to prepare to comply with a new federal rule that will require them to use E-Verify to verify the employment eligibility of new hires scheduled to take effect May 21, 2009. The rule will only affect federal contractors who are awarded a new contract after May 21st that includes the Federal Acquisition Regulation (FAR) E-Verify clause. Federal contractors may **NOT** use E-Verify to verify current employees until the rule becomes effective and they are awarded a contract that includes the FAR E-Verify Clause.

The new rule implements Executive Order 12989, as amended by President George W. Bush on June 6, 2008, directing federal agencies to require that federal contractors agree to electronically verify the employment eligibility of their employees. The amended Executive Order reinforces the policy, first announced in 1996, that the federal government does business with companies that have a legal workforce. This new rule requires federal contractors to agree, through language inserted into their federal contracts, to use E-Verify to confirm the employment eligibility of all persons hired during a contract term, and to confirm the employment eligibility of federal contractors' current employees who perform contract services for the federal government within the United States.

Interested persons can review the final regulation and read frequently asked questions about this new rule on the internet at the following cites:

- ✓ Final Regulation at http://edocket.access.gpo.gov/2008/E8-26904.htm
- ✓ Frequently Asked Questions at http://www.uscis.gov/portal/site/uscis/menuitem.5af9bb95919f35e66f614176543f6d1a/?vgnextoid=cb2a535e0869d110VgnVCM1000004718190aRCRD&vgnextchannel=75bce2e261405110VgnVCM1000004718190aRCRD

If you have questions or concerns about the matters discussed in this publication or other human resources, employee benefits or compensation matters, wish to obtain information about arranging for training or presentations by Ms. Stamer, wish to suggest a topic for a future program or publication, or wish to request other information or materials, please contact Ms. Stamer via telephone at (214) 270-2402 or via e-mail to Cstamer@Solutionslawyer.net. .

More Information

We hope that this information is useful to you. You can register to receive future updates and information about upcoming programs, access other publications by Ms. Stamer and other helpful resources or additional information about Ms. Stamer at CynthiaStamer.com or by contacting Ms. Stamer directly. If you or someone else you know would like to receive updates about developments on these and other human resources and employee benefits concerns, please be sure that we have your current contact information – including your preferred e-mail- by creating or updating your profile at CynthiaStamer.com. You also can register to participate in the distribution of these updates by registering to participate in the Solutions Law Press HR & Benefits Update Blog at http://slphrbenefitsupdate.wordpress.com.