SECTION OF REAL PROPERTY | TRUST & ESTATE LAW
eReport

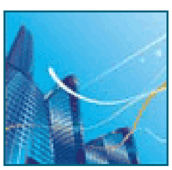
A Bi-Monthly Electronic Publication for Section Members December 2009

Section News

Free Group and Committee Conference Calls are an RPTE Member Benefit
A significant benefit of being a member of the Real Property, Trust and Estate Law Section is that you may join in on FREE group and committee conference calls. The calls include substantive discussions of legal hot topics and offer a chance to speak with, or listen to, colleagues from around the country as they address the latest issues facing practitioners. Click here to view the current conference call schedule.

Mark Your Calendars for RPTE's 21st Annual Spring Symposia in Philadelphia
The Symposia provides a great opportunity to network with your peers and earn CLE credits. Click here for dates and hotel information.

Trust and Estate News Real Property News



Real Property News

Send Us Your Residential Foreclosure News
The editors of the *eReport* are aware that various states, municipalities and courts have implemented laws, rules and orders to address the residential foreclosure crisis. We plan periodically to post information about particular state and local efforts. If you have news on what your state, local municipality or local courts have implemented, please send a short description to Cheryl Kelly.

Is Conversation from Subchapter S Elected Status to Partnership Status Right for Your Business Entity?
William Sylvester and C. Bradley Cherry
Real estate may be held by an entity taxed as an S Corporation. Bill Sylvester and Brad Cherry analyze the issues involved in converting an S Corporation to an entity

Technology and Law Practice Management

Don't Miss TechShow 2010
The RPTE Section is a program promoter of ABA TECHSHOW 2010, a 3-day technology-related seminar hosted by the ABA Law Practice Management Section. Review program information at www.techshow.com and get a special registration discount by using the RPTE program promoter code EP1011. Find out more about this year's ABA TECHSHOW.

Are you having trouble finding the information you need on the ABA website?Learn how easy it is to search the ABA website for both RPTE and ABA content. Click here to find search tips and tricks.

CLE Spotlight

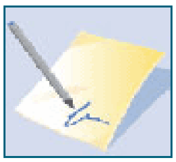
Real Property CLE
Negotiating Agreements in a Cross-Cultural Setting: When Yes Might Mean No
Webcast/Teleconference
Date: January 20, 2010
Time: 12:00 P.M. - 1:30 P.M. Central

Trust and Estate CLE
The Top Thirty (or so) List of Both Personal and Business Insurance Planning Mistakes:
And How to Avoid (or at Least Fix) Them
Webcast/Teleconference
Date: January 12, 2010
Time: 12:00 P.M. - 1:30 P.M. Central

Group & Committee News

taxed as a partnership.

Creditors Beware: Foreclosure Sale Avoided As Preferential Transfer Under § 547(b) of The Bankruptcy Code When Sale Resulted in Creditor Receiving More Than It Would Have in A Chapter 7 Liquidation
Allison E. Graves
A foreclosure may not be as final as many creditors believe, especially when the foreclosure sale results in a credit bid for property worth substantially more than the amount of the debt. As Allison Graves details in her article, a Bankruptcy Court in Texas recently held that a debtor in bankruptcy can avoid a foreclosure sale of real property conducted within 90 days of the filing of the debtor's petition for bankruptcy if the value received at the foreclosure sale is more than the creditor would have received under a liquidation of the property in bankruptcy if the sale had not occurred.



Trust & Estate News

New Version of 419 Plans: An Impending Train Wreck
David S. Neufeld

Proposed Regulations for Type III Supporting Organizations
Stephanie Casteel

Final Regulations Under Section 2053 Governing Estate Tax Deductions for Administration Expenses and Claims Against Estates
Steve Akers

Estate of Christiansen v. Commissioner -- Eighth Circuit Upholds Formula Disclaimer Over Public Policy Objections (or "Friday the 13th Massacre of IRS Position on Defined Value Clauses")
Steve Akers

Cynthia Marcotte Stamer provides updates on the latest developments in the Employee Benefits area:1) Department Of Labor Announces Plans To Expand Reporting Employee Benefits, Wage & Hour, OSHA & Other Reporting & Disclosure Requirements & To Implement Other New Employee Benefit Regulations

2) Mishandling Employee Benefit Obligations Creates Liabilities For Distressed Businesses & Their Business Leaders

3) Employee Benefit Plan Sponsors & Fiduciaries Urged To Review Bonding, Credentials of Staff & Service Providers

Special Investors and Investment Structure Group

The Special Investors and Investment Structure group has recently launched its blog on LinkedIn. The blog represents the group's efforts to add value to its membership by enhancing the members' communication, interaction, and free exchange of ideas and information. The group is now working to establish a sub-blog for each of its committees within the same blog space. To read more on the group, click here and, to join the group's blog, click here.

REAL PROPERTY
Real Estate Finance Group
On January 11, 2010 Real Estate Financing group will be holding a quarterly conference call. The topic will be a discussion about the recent changes to the REMIC rules, click here for more.

TRUST & ESTATE
Non-Tax Estate Planning Considerations Group

The group consists of six very active committees, addressing such topics as asset protection planning, sophisticated issues in insurance planning, ethical issues in estate administration, estate planning for individuals with chronic illness, estate planning software and other business solutions, the uses for collaborative law, and the adoption of many uniform acts that impact our practice, and much more. To learn more, click here.

Young Lawyers Network

Get involved in the Section by helping in the development of the Section's comment projects. Click here for more information.

Law Students

Let the 2010 Law Student Writing Contest be your

Under ERISA

Would you like to write an article for the eReport?

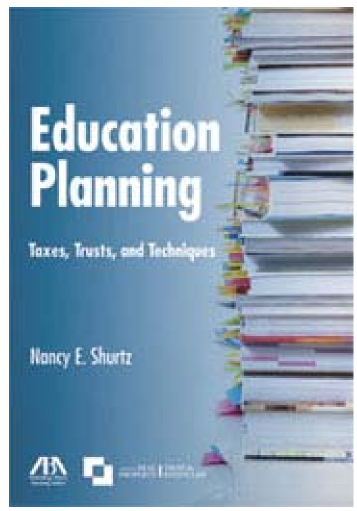
If you have something to say, and would like your article considered for the eReport, simply email Susan Talley, Editor, at stalley@stonepigman.com for further details.

opportunity for recognition. To find out more, click here.

Join a Committee Today!

RPTE members can join a group or committee (or several) online at www.abanet.org/rpte/join. For questions regarding membership, contact the Section at (312)988-5651 or email Bunny Lee at leeb@staff.abanet.org.

New Book from RPTE



Education Planning: Taxes, Trusts, and Techniques
Nancy Shurtz

To help you advise clients who are scrambling to figure out how to finance their children's education, **Education Planning: Taxes, Trusts, and Techniques** offers an in-depth guide to the strategies, vehicles, and estate and tax planning available to these families. While the text focuses on the popular yet complex 529 plans, it also provides the planner with information about all other available college savings vehicles.

In eight parts and 36 chapters, **Education Planning: Taxes, Trusts, and Techniques** covers the complex vehicles that can be used in saving for college and the various forms of aid available when those savings vehicles prove inadequate. The first part of the book examines the benefits and costs of a college education while providing a broad overview of the various strategies for paying for college.

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.

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Section News

2010 RPTE Spring Symposia

The Real Property, Trust and Estate Law Section's 21st Annual Spring Symposia and Council Meeting will be held in Philadelphia, PA on May 6 through May 7, 2010. 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 Philadelphia Marriott Downtown. Take this opportunity to earn CLE credit while networking with colleagues and learning about the Section's activities and benefits. Come explore the exciting city of Philadelphia, Pennsylvania.

Look for more information soon on the RPTE website.

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Technology

24th Annual ABA TechShow 2010

The World's Premier Legal Technology Conference and Expo

Chicago, Illinois - March 25-27, 2010

The Real Property, Trust and Estate Law Section is a "Program Promoter" of the 24th Annual ABA TechShow 2010. This year, ABA TECHSHOW offers over 50 technology CLE programs and training sessions within a large variety of topical tracks (with multiple sessions each) focused on areas including trial skills, mobility, smart phones, e-discovery, solo and small firms, large firms and corporate counsel, finance, Macintosh, marketing and social networking, finance, and advanced IT. The two-day expo typically showcases more than 100 vendors displaying legal products and services. Registration for ABA TECHSHOW is now open. **Use the special RPTE code EP1011 to obtain a special rate**. Click here to access the TechShow website and find out all the information you may want about this exciting and informative program.

Finding ABA Content with the ABA Search Engine

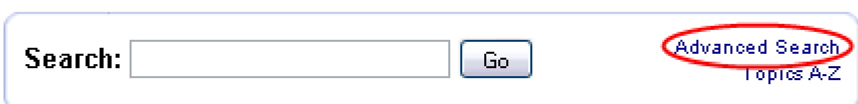
The American Bar Association's website search engine is powered by Google via a Google Search Appliance. Many of the same tips and tricks for finding information on the Internet at large with Google also apply to searching the ABA website.

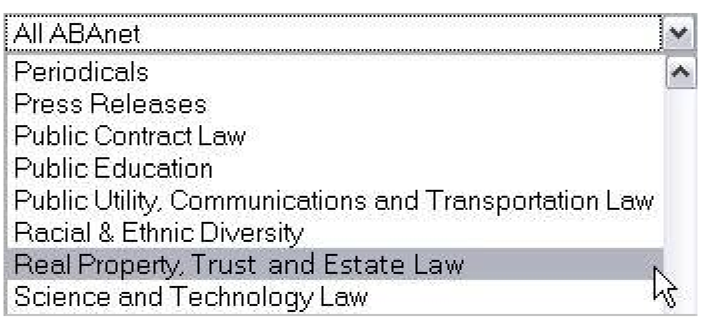
There are a number of special operators that can be used to access advanced search functions from the basic Google search box located at the top of any ABA webpage. These same advance search features can alternatively be accessed by clicking on the "Advanced Search" link to the right of the search box.

Searching for information in a specific ABA section/entity's website

One powerful advanced search feature is to limit a search to materials in a specific ABA section/entity's website. To do this, enter the keywords you want to search, followed by the operator "site:" and the section/entity's website address. For example, the main web address of the RPTE section is www.abanet.org/rpte.html, To limit a search to just materials in the RPTE section website, enter the keywords you want to search for, followed by "site:www.abanet.org/rpte" in the basic search box. So to search for the term 401k in only the RPTE site, you would enter [401k site:www.abanet.org/rpte] in the basic search box.

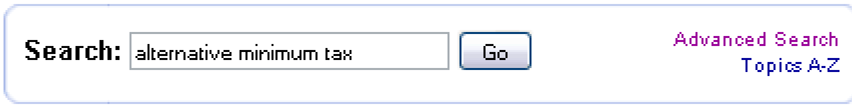
An alternative way to limit a search to materials in a specific section/entity website is to click on the Advanced Search link, and on the advanced search page select the name of the section/entity to limit your search to in the "ABA Entity Filter" pulldown menu. Then enter the terms you want to search for in one of the other advanced search fields (explained below), and click on a "Search the ABA" button.





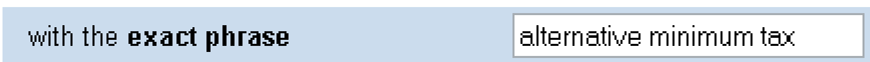
Searching for All of the Words

By default Google will search for materials containing all of the keywords you enter into the basic search box, although not in any particular order or grouping. For example, searching for the words [alternative minimum tax] might return documents with the words alternative, minimum, and tax scattered throughout the document in any order, as well as documents with the words grouped together in the order in which you typed them.



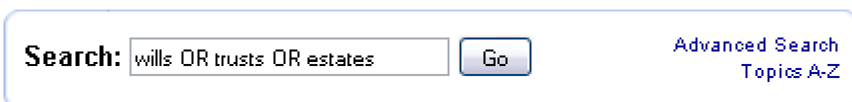
Searching for an Exact Phrase

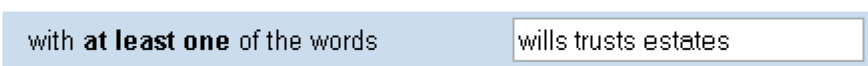
To search for materials which contain keywords grouped together in the exact sequence in which you enter them, type the keywords, enclosed in quotation marks, into the basic search box. For example, entering the keywords ["alternative minimum tax"] (enclosed in quotation marks) in the basic search box will search for documents containing the exact phrase "alternative minimum tax." Alternatively, you can achieve this by entering the keywords into the advanced search field labeled "with the exact phrase."



Searching for At Least One of the Words

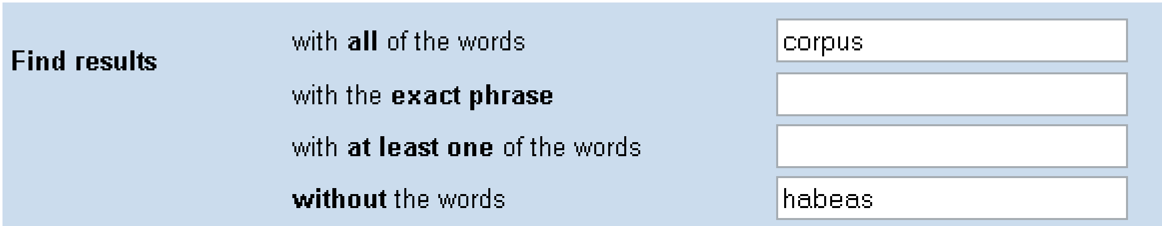
To search for documents containing at least one of the words you search for, place the word "OR" between each of the keywords in the basic search box. For example, entering the terms [wills OR trusts OR estates] in the basic search box will return documents containing at least one of those keywords. Alternatively, you can enter just the keywords in the advanced search field labeled "with at least one of the words."





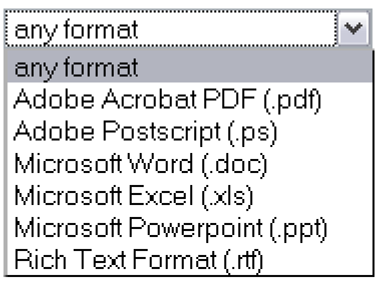
Excluding Words from a Search

In order to exclude certain keywords from a search, you can enter the words you want to search and the words you want excluded into the basic search box, but put a minus sign in front of words you want to exclude. For example, if you are interested in searching for the word "corpus," but want to exclude documents with the term "habeas," enter the search terms [corpus -habeas] into the basic search box. Alternatively, you can enter the words you want to exclude into the advanced search box labeled "without the words," and enter the words you want to search in one of the other advanced search fields such as the "with all the words" field.



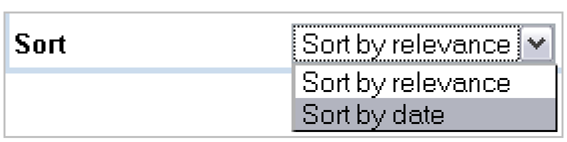
Searching for Specific File Types

To search for materials only in a certain format, enter the keywords you want to search for, then the operator "filetype:" followed by the type of file, such as pdf, doc, xls, etc. Alternatively, you can select a file type from the "File Format" pulldown menu on the Advanced Search page. This could be used to search for presentations, articles, and other materials in certain formats such as PDF or PowerPoint on the ABA website.



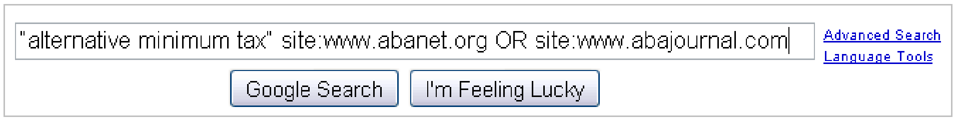
Sorting Search Results By Date

Google search results are listed in order of relevance by default. In order to have search results returned sorted by date instead, change the advanced search pulldown menu labeled "Sort" from "Sort by relevance" to "Sort by date."



The search engine built into the ABA website does not currently sort by date ranges, however, you can accomplish this with the search engine at www.google.com.

The search engine at www.google.com has more sophisticated options for sorting by date, such as options to search for information from specific time periods and date ranges. To search the ABA website using these advanced date search options, enter any keywords you want to search into the search box at www.google.com, followed by the keyword "site:" and the URL of the ABA website directory you want to search. You can enter more than one URL/website directory to search at a time or separate multiples with the OR operator. For example, if you want to search for the exact phrase "alternative minimum tax" in both the main ABA site and the ABA Journal site, enter the search ["alternative minimum tax" site:www.abanet.org OR site:www.abajournal.com].



When the search results appear, click on the link labeled "Show options" next to the blue plus sign at the top of the page. A sidebar will appear on the left side of the page with menu items, including the time options "Latest," "Past 24 hours," "Past week," Past year," and "Specific date range." Selecting one of these time options will limit the search results to only documents from the corresponding time period.

You can read more about advanced Google searching for the ABA's website at http://www.abanet.org/search/searchtips.htm and for the wider Internet at http://www.google.com/support/websearch/bin/answer.py?answer=136861.

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Group and Committee News

REAL ESTATE FINANCE GROUP QUARTERLY CONFERENCE CALL
JANUARY 11, 2010

RECENT CHANGES TO THE REMIC RULES

On Monday, January 11, 2010, the ABA Real Estate Financing Group will be holding a quarterly conference call. The topic will be a discussion about the recent changes to the REMIC rules that were enacted by the IRS. Have these changes made it easier or more difficult for specially serviced loans or loans that are about to go into special servicing? William Rothschild of Sutherland in Atlanta, GA will be moderating the call. All are welcome to attend. You do not have to be an ABA member to join the discussion. The discussion will be a prelude to the one of the three programs being presented by the Real Estate Finance group at the Section's 2010 Annual Spring Symposia, held this May 6-7 in Philadelphia, PA. The call will take place January 11 from 12:00 p.m. to 1:00 p.m., CT. The call in number is 1.800.504.8071, passcode 9885590.

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Group and Committee News

The Non-Tax Estate Planning Considerations Group consists of six very active committees: 1. Uniform Acts for Trust and Estate Law, 2. Emotional and Psychological Issues in Estate Planning, 3. Non-Tax Issues Affecting the Planning and Administration of Estates and Trusts, 4. Insurance and Financial Planning, 5. Asset Protection Planning, and 6. Economics and Technology of the Practice.

The group will be meeting in person at the Spring Symposia. Our meeting will feature a discussion of securities law issues (such as qualified purchaser issues) affecting gifts to trusts, a discussion of Non-Tax "Hot Topics", and a discussion of Estate Dispute Resolution. Our committees will also be busy at the Spring Meeting. The Emotional & Psychological Issues in Estate Planning Committee will be hosting a lecture on estate planning for individuals with chronic illness and the Uniform Laws committee will be presenting an update on the new Uniform Laws relevant to our practice. The Insurance and Financial Planning Committee is busy putting together a potential presentation for the Fall meeting which will explore the many ways in which the current uncertainty in the valuation of life insurance policies may impact our clients.

Can't be there in person? Many active group members are not able to attend in-person meetings, but there are still ways to get involved. Our group hosts substantive discussions every other month. Each of our committees will be hosting one of our group calls this year. Our schedule is set forth below and our committees are hard at work on the topics to be discussed each call.

Non-Tax Estate Planning Considerations Group Bi-Monthly Group Calls 4:00 – 5:00 ET	
Date	**Committee**
January 14, 2010	Economics and Tech. of the Practice
March 11, 2010	Non-Tax Aspects of the Administration of Trusts and Estates
May 13, 2010	Emotional & Psychological Issues
July 8, 2010	Insurance and Financing Planning
September 9, 2010	Uniform Laws

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Young Lawyers

One of the most important ways the Real Property, Trust and Estate Law Section contributes to the improvement of the law is through the submission of comments on proposed tax regulations and guidance to the IRS, Treasury, Congress, and other governmental authorities. The comment projects are always of high quality, and are appreciated by policymakers and practitioners alike as fair and objective discussions of the issues at hand.

One way a Young Lawyer can get involved in our Section is to help in the development of the Section's comment projects, which provide the opportunity to:

- Work on substantive comment projects alongside experts in the field;
- Get more involved with Section committees; and
- Help improve the legal system.

If you're interested in being involved in these projects, please sign up for a Group or Committee and volunteer when the comment opportunities arise. If you have any questions, please contact, Elizabeth Ochoa, the YLN group chair.

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Law Student News

2010 Law Student Writing Contest

The Real Property Trust and Estate Law Section's 2010 Student Writing Contest is open to all law and LL.M students currently attending an ABA-accredited law school. It is designed to encourage and reward law student writing on real property, trust and estate law subjects of general and current interest. Complete rules as well as the entry form are available online. For more information, please contact Amanda Pauli at paulia@staff.abanet.org. The deadline for submitting essays is June 18, 2010.

The 2010 first place winner will receive $2,500 and a one year membership in the RPTE Section. The winner will also receive free round trip airfare and weekend accommodations to attend the RPTE Fall Leadership Meeting, November 11-14 at the Charleston Place Hotel in Charleston, S.C. (valued at approximately $1,000). In addition, the first place winner's essay will be considered for publication in a future issue of the *Real Property, Trust and Estate Law Journal* and will be announced in *Probate & Property*, the Section magazine. Both the second and third place winners will be announced in *Probate & Property*. The second place winner will receive $1,500, and the third place winner will receive $1,000.

Is Conversion from Subchapter S Elected Status to Partnership Status Right for Your Business Entity?

by

William Sylvester and C. Bradley Cherry
Baker Donelson Bearman Caldwell & Berkowitz, PC

One truism about the current market is that the cost of converting from certain types of entities formed or currently electing to be taxed as a subchapter-S ("sub-S") corporation to the partnership form, is becoming temporarily less burdensome. In some cases, the usual tax load of converting a sub-S will even be non-existent for the present time.

While the use of LLCs, LPs, general partnerships and other entities taxed as partnerships has certain advantages in many settings, sub-S corporations are also used to achieve similar tax results. Accordingly, many unincorporated entities are formed, elect to be taxed as a corporation, then elect sub-S status. Nevertheless, certain activities are clearly better pursued in a partnership structure rather than through a sub-S election, such as owning real estate or other passive investments, activities which may produce losses, certain estate planning strategies, and investment activities requiring multiple types of ownership or equity rights.

The format for converting a sub-S to a partnership involves one of three methodologies: (1) an asset transfer, (2) a stock transfer or (3) a change in election, under the "check-the-box" regulations, which is available only to unincorporated entities (Treas. Reg. § 301.7701-3).[1] This Alert focuses on the third route, since in many cases lender and third party consents generally are not necessary, or desirable, for a simple change under the check-the-box regulations.[2]

The IRS views a change in election, from an association (i.e., an unincorporated entity electing sub-S federal tax status) to a partnership, as resulting in the following deemed consequences: "The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership." Treas. Reg. § 301.7701-3(g)(ii). One effect of this sequence is that each owner will receive his or her share of corporate level gain, if any, under Internal Revenue Code (IRC) § 1366.[3] Given the falling appraised asset values (some observers report losses in the last 24 months at 40%, or more, depending on the type of property, the region, and other factors), gain that accumulated over earlier years may be significantly reduced now.

A change in election can be made by filing Internal Revenue Service Form 8832 and will be effective on the date specified by the entity. The effective date cannot be more than 75 days prior to, or more than 12 months after, the date on which the election is filed. Treas. Reg. § 301.7701-3(c)(iii).[4] A change in election must be approved by all of the owners. A new deprecation period will start, for the entity, using an adjusted basis equal to the fair market value of the distributed assets.

The owners would be best advised to have the assets formally appraised in connection with a proposed check-the-box conversion. Unlike charitable contributions, including conservation easements, there are no applicable "qualified" appraisal rules as to when an appraisal should be prepared (or even requiring that one be completed). Owners might choose to wait until they believe the market has hit the bottom before implementing this strategy.

The planning opportunities associated with the conversion discussed above require specific facts and circumstances.

1. A change in election to be taxed as a partnership under the "check-the-box" regulations changes the entity classification for federal income tax purposes only. State law must be consulted with respect to tax consequences.
2. A quick review of a sampling of the "negative" covenants found in portfolio loans, life company loans and commercial mortgage backed securities loans did not disclose any potential defaults, but in every case this should be checked specifically. This Alert assumes that no negative loan covenants will be violated by using the approach set forth herein. If consents are required, such consents may be difficult to obtain, particularly while the market remains somewhat unsettled.

3. The entity will recognize gain under IRC § 311 equal to any excess of the fair market value of its assets over their adjusted basis to the entity. In cases where a shareholder's pro rata portion of the inside net asset tax basis is different from the shareholder's basis in the stock or other ownership interest in the sub-S (in each case before the deemed distribution), then additional gain or loss may be incurred due to the deemed receipt of the assets in liquidation. This generally will not occur for persons who have been owners since the inception of sub-S status but may apply to persons purchasing or inheriting sub-S interests after formation.
4. An entity that makes an election under Treas. Reg. § 301.7701-3(c)(1)(i) by filing Internal Revenue Service Form 8832, cannot change its classification by election again during the 60 months succeeding the effective date of the election. An election by a newly formed entity that is effective on the date of formation is not considered a change for purposes of this limitation.

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William R. Sylvester, is a shareholder in the Birmingham office of Baker Donelson Bearman Caldwell & Berkowitz, PC. He has a strong background lecturing and writing on advanced techniques involving tax deferred real property exchanges and focuses his practice in the areas of commercial real estate development, business and tax planning. More regarding Mr. Sylvester's practice can be found by clicking on the following link:

http://www.bakerdonelson.com/Bio.aspx?NodeID=32&PersonID=11739

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C. Bradley Cherry, is an associate in the Birmingham office of Baker Donelson Bearman Caldwell & Berkowitz, PC. He manages a diverse commercial real estate portfolio practice and has guided clients through multifamily and golf course development transactions, acquisitions of manufacturing sites in the southeast, as well as providing banking and financial counsel for clients. More regarding Mr. Cherry's practice may be found by clicking on the following link:

http://www.bakerdonelson.com/Bio.aspx?NodeID=32&PersonID=11740

CREDITORS BEWARE: FORECLOSURE SALE AVOIDED AS PREFERENTIAL TRANSFER UNDER § 547(b) OF THE BANKRUPTCY CODE WHEN SALE RESULTED IN CREDITOR RECEIVING MORE THAN IT WOULD HAVE IN A CHAPTER 7 LIQUIDATION

By Allison E. Graves[1]
Thompson Coburn LLP
www.thompsoncoburn.com

In a recent decision, the United States Bankruptcy Court for the Southern District of Texas (the "Court") held that the United States Supreme Court's decision in *BFP v. Resolution Trust Corp.* does not preclude a debtor from having a pre-bankruptcy foreclosure sale of its property set aside as a preferential transfer where the creditor that foreclosed received more than it would have under a chapter 7 liquidation sale of the property. *In re Villarreal*, 413 B.R. 633 (Bankr. S.D. Tex. 2009).

In *Villarreal*, Armando Orta and various other parties (the "Orta Parties") held a third deed of trust (the "Deed of Trust") on certain real property owned by Gregorio B. Villarreal and Estella Villarreal (together, the "Debtors"), consisting primarily of a restaurant and a ballroom (the "Property"). The Deed of Trust secured an obligation owed by the Debtors to the Orta Parties in the original principal amount of $70,000.00 (the "Debt"). David Showalter (the "Trustee") was the trustee under the Deed of Trust. After the Debtors defaulted on their obligations to the Orta Parties, the Trustee conducted a foreclosure sale of the Property under the Deed of Trust (the "Foreclosure"). The Trustee was the successful bidder at the Foreclosure by credit bidding the outstanding amount of the Debt.

Less than two months after the Foreclosure, the Debtors filed a petition for relief under Chapter 13 of the Bankruptcy Code. The Debtors thereafter filed an adversary proceeding seeking to avoid the Foreclosure of the Property as a preferential transfer under 11 U.S.C. § 547(b).

Section 547(b) of the Bankruptcy Code provides that a trustee may avoid the transfer of an interest of the debtor in property as a preference if the transfer was:

(1) To or for the benefit of a creditor;
(2) For or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) Made while the debtor was insolvent;
(4) Made –
  (A) On or within 90 days before the date of the filing of the petition; or
  (B) Between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) Enabled such creditor to receive more than such creditor would receive if –
  (A) The case were a case under chapter 7 of this title;
  (B) The transfer had not been made; and

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(C) Such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b) (emphasis added).

At trial, there were three major disputed factual issues: (1) whether the Foreclosure was conducted at the proper place and in the proper manner; (2) whether the Debtors were insolvent at the time of the Foreclosure; and (3) whether the Foreclosure resulted in the Orta Parties receiving more than they would have in a hypothetical liquidation under chapter 7 of the Bankruptcy Code.

The Court determined that the Foreclosure had been conducted at the proper place and in the proper manner and that the Debtors were insolvent at the time of the Foreclosure. In analyzing the third disputed issue, the Court found that, pursuant to § 547(b)(5) of the Bankruptcy Code, the Orta Parties did in fact receive more through the Foreclosure than they would have in a chapter 7 liquidation. The Property was worth approximately $4,020,000.00 at the time of the Foreclosure, and the obligations secured by the Property were less than $750,000.00, including the amount of the Debt. Thus, the Orta Parties received at least $3,270,000.00 in value to satisfy the Debt, which principal amount did not exceed $70,000.00. In contrast, in a chapter 7 liquidation sale of the Property, the Orta Parties, as oversecured creditors, would have received approximately $100,000.00 in principal, interest, fees and expenses, which amount is substantially less than the value received through the Foreclosure.

However, the Court did not end its analysis there. Rather, it then considered whether such a § 547(b)(5) analysis of how much the Orta Parties would have received in a chapter 7 liquidation was even proper or whether the Supreme Court's decision in *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), mandated a finding that a chapter 7 liquidation sale of the Property would not have realized a greater sale price than was attained through the Foreclosure.

In *BFP*, the Supreme Court considered whether a mortgage foreclosure sale that resulted in a sale of the foreclosed property for less than fair market value was a fraudulent conveyance under § 548 of the Bankruptcy Code. One of the elements of a fraudulent transfer under § 548 is that the debtor "received less than a reasonably equivalent value" for the property that was transferred. The debtor in *BFP* argued that the foreclosure sale of his property did not result in the receipt of reasonably equivalent value in that, at the time of the foreclosure sale, the property had a fair market value of $725,000.00 but was sold for only $435,000.00. The Supreme Court rejected the debtor's argument. It held that the amount obtained from a non-collusive foreclosure sale conducted in accordance with applicable state law was, as a matter of law, "reasonably equivalent value." The Supreme Court found that any other ruling would interfere with the essential state interest of ensuring the security of the titles to real estate.

Courts that have held the *BFP* analysis to apply in a § 547(b)(5) context have assumed that a chapter 7 liquidation would produce the same proceeds as a pre-petition foreclosure sale conducted in accordance with state law. *Villareal*, 413 B.R at 640. The *Villareal* Court did not adopt the reasoning of this line of cases. *Id.* Rather, the Court held that the *BFP* analysis does not apply to § 547(b)(5) because the plain language of this section precludes such a judicial interpretation.

In analyzing the application of *BFP* to § 547, the Court focused on the basic rule of statutory construction that judicial inquiry ends when a statute is found to be plain and unambiguous on its face. *Id.* at 642. In clear and plain language, § 547(b)(5) requires a court to determine both the value of what the creditor actually received from the pre-petition transfer of property and the value of what that same creditor would have received in a chapter 7 liquidation of the debtor's property if the pre-petition transfer had not occurred. *Id.* at 639. Once these two values are determined, the court must then undertake a straightforward mathematical comparison of these two numbers: if the amount actually received is greater than the amount that would have been received in a Chapter 7 liquidation, the requirement of § 547(b)(5) is met. *Id.* The language of § 547 in no way suggests that a Court may simply assume that a chapter 7 liquidation will never result in a greater sales price than a pre-petition foreclosure sale. "There is nothing in § 547 equivalent to § 548's ambiguous use of 'value' . . . There is no ambiguity about the meaning of 'more' or 'chapter 7 liquidation' or the clear purpose of § 547." *Id.* at 642. Thus, although the same the federalism concerns raised in *BFP* with respect to state property laws apply equally in a § 547(b) avoidance action and a § 548 fraudulent conveyance action, the plain language of § 547(b) does not permit a court to find as a matter of law that a chapter 7 liquidation will never result in a creditor receiving more than it did in a pre-petition foreclosure sale.

The practical effect of this ruling is that a foreclosure sale can never truly be considered final until at least 91 days after the sale occurs because, if a debtor files for bankruptcy in the interim, he may be able to have the sale avoided as a preferential transfer under § 547(b). Creditors that credit bid at a foreclosure sale where the property is worth more than the amount of the debt should be especially aware of the possibility of the sale being avoided in bankruptcy.

New Version of 419 Plans: An Impending Train Wreck

By David S. Neufeld, JD, LL.M., AEP[1]

SYNOPSIS: While properly designed 419 Plans have thrived after the IRS attack on DBO Plans two years ago, some new plans may appear compliant but in fact violate IRS guidance.

In the old serial movies, when the hero saw the train heading for a booby trapped section of track he would race fearlessly to the track switch and divert the train from certain doom just in the nick of time. Sometimes tax lawyers, CPAs and other advisors need to do the same to try to keep consumers of tax advice from the proverbial train wreck, albeit without the rousing music, the horse and the grateful beauty.

While it is a fact that employers can make deductible contributions to certain welfare benefit plans, often called 419(e) Plans, using cash value life insurance as a vehicle to fund post-retirement medical benefits,[2] it is also generally understood that the IRS has taken a position in Revenue Ruling 2007-65 that no contribution to a 419(e) Plan used to acquire life insurance that provides a pre-retirement death benefit can be deducted.[3] The train destined for certain doom in this instance is those uninformed taxpayers who are participating in plans that “creatively” interpret the revenue ruling. Specifically these plans promise death benefits funded by term insurance or cash value insurance and for which the term cost is deducted. Unless those with the right information divert that train these taxpayers are destined for disaster.

BACKGROUND

Prior to October, 2007 it was generally accepted that welfare benefit plans could offer a variety of benefits, including pre-retirement death benefits, all of which could be funded with contributions that would be used to acquire cash value life insurance policies. One popular plan design, which would offer an array of post-retirement medical benefits to a company's qualifying employees, is sometimes referred to as a post-retirement medical benefit plan ("PRMB"). As this plan is governed by ERISA, there are specific non-discrimination, participation and funding requirements. By using a cash value life insurance policy as a funding mechanism the assets in the plan, which had been contributed on a tax deductible basis, can grow tax free and be distributed to participants free of income tax under specific circumstances. In its purest form this type of plan would not offer any death benefits. Instead, the life insurance owned in the Plan would pay proceeds which would be to be retained by the plan; these insurance proceeds within the plan might then be used to fund medical benefits into the future.

At the other end of the spectrum another popular plan design would offer only death benefits, colloquially termed a Death Benefit Only, or DBO, Plan. These plans might offer a pre-retirement death benefit funded by any type of insurance, term or cash value. Not being subject to ERISA these plans were not subject to many of the rules governing the PRMB plan, including the non-discrimination and funding rules. Finally there were plan designs that offered a hybrid version of these two plans. These plans offered both the pre-retirement death benefit and the post-retirement medical benefit, using a variety of life insurance policies.

In October, 2007 the IRS issued a revenue ruling and two notices (Rev. Rul. 2007-65, Notice 2007-83 and Notice 2007-84). These directives have been to subject of several articles, some of which have been insightful and accurate. For an extended description and interpretation of this guidance see Neufeld, "The 419(e) Plan: Reports of its Death Have Been Greatly Exaggerated," *Journal of Financial Service Professionals*, Oct. 2008, page 56. In a nutshell this guidance stated that it was the IRS' view that no contribution that funded death benefits payable by life insurance, whether the plan was a DBO or a hybrid, is deductible, based on IRC section 264(a)(1). The argument is that the company that sets up a welfare benefit plan providing death benefits funded with life insurance, even if through an irrevocable trust, is indirectly the beneficiary of the life insurance.[4] As such, section 264(a)(1) prevents the company from deducting any part of the contribution. The life insurance policy in the IRS' example is a cash value policy.

Relying more on alchemy than science, some taxpayers might be employing a plan that seem on its face to satisfy the IRS' concerns with cash value life insurance by measuring itself only against the specific facts in the ruling. However these are truly still in violation of the ruling and present impending doom since it ignores the actual holding.

THE APPROACHING TRAIN WRECK

Remarkably, when faced with clear, if arguably wrong, IRS guidance, some still find programs that ignore such guidance. The argument for such programs proceeds as follows: since the facts of the ruling address only a cash value life insurance policy a company may sponsor and fund a 419(e) plan that provides death benefits funded by a term policy and deduct all of the premium or fund it with a cash value policy and deduct that portion of the premium that equates to the term cost.

This is not even arguably an accurate interpretation of the IRS guidance. While it sounds plausible to those without a technical background those who purport to be tax advisors should know better. The IRS' position is not limited to the specific facts of the ruling; just because they illustrate the case with a cash value life insurance policy does not mean the holding is limited to cash value insurance. In fact the IRS says as much: "The conclusions . . . are the same . . . regardless of the type of life insurance policy."[5]

To appreciate this one must appreciate section 264(a). Section 264(a) does not distinguish between term insurance or cash value insurance. It makes the straight forward statement that if a company is directly or indirectly the beneficiary of a life insurance policy the premiums it pays are not deductible. As the IRS' rationale in the guidance is based on this provision then it is inescapably the IRS' position that no contribution used to acquire term insurance or cash value insurance is deductible when policy proceeds is used to pay death benefits.

In a pre-October 2007 world this mistake might have led only to a tax deficiency and some minor penalties. In a post-October, 2007 world if a cash value policy is employed and the term equivalent portion is deducted this can now expose taxpayers and advisors to massive penalties for engaging in a listed transaction if they fail to adequately disclose the transaction. If those buying this scheme are convinced they can do it, it is safe to guess that they might also be convinced that this is not a listed transaction, and fail to adequately disclose, thereby exposing themselves to hundreds of thousands of dollars in penalties.

WHAT CAN YOU DO FOR YOUR CLIENTS

1. Divert your clients away from plans offering death benefits through life insurance where the contributions are being deducted from the company's taxes. If they wish to use a welfare benefit plan they should be directed to the safer PRMB plans.

2. If your clients insist on going into such a plan try to dissuade them from taking the deduction for the term portion that funds the death benefit.

3. If your clients insist on going into the plan and deducting the term equivalent portion of a cash value policy they should be sure to file the Form 8886 notifying the IRS that they are engaged in a listed transaction. In addition you should file the Form 8918 notifying the IRS that you are a material advisor to a client that has engaged in a listed transaction if in fact you are a material advisor. Failure to do either will result in penalties that can reach $200,000 per year for the client and other penalties for you.

SUMMARY

Sometimes all that stands between our clients and certain disaster is an advisor who is astute and alert. Be that hero to your clients by diverting them away from 419(e) Plans that offer pre-retirement death benefits and purport to do so on a tax deductible basis, at least until the IRS is proven wrong in a court.

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[2] Notice 2007-84, 2007-45 IRB 960

[3] Rev. Rul. 2007-65, 2007-45 IRB 949

[4] There are valid arguments that the IRS position is wrong and would be overruled if subject to legal challenge. See Neufeld, "The 419(e) Plan: Reports of its Death Have Been Greatly Exaggerated," *Journal of Financial Service Professionals*, Oct. 2008, at page 61. Until then this is the IRS position and clients need to make informed decisions prior to choosing to take the opposite position.

[5] Rev. Rul. 2007-65, 2007-45 IRB 949

Proposed Regulations for Type III Supporting Organizations

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On September 23, 2009, the IRS released long-awaited proposed regulations regarding Type III supporting organizations (SO). As expected, non-functionally integrated Type III SOs are required to annually distribute 5% of the fair market value of their non-exempt-use assets, but the five supported organization limit of the Advance Notice of Proposed Rulemaking (ANPR) was not adopted. There is a reasonable cause exception for failure to meet the distribution requirement, and the IRS may provide for a temporary reduction of the annual distributable amount in the case of a disaster or emergency. In addition to the distribution requirement, non-functionally integrated Type III SOs must meet an attentiveness test: the SO must distribute at least 1/3 of the distributable amount to one or more supported organizations that are attentive to the SO and with respect to which the SO meets the responsiveness test. For functionally integrated Type III SOs, the expenditure and assets tests contemplated by the ANPR were eliminated, and only a modified "but for" test was adopted. Type III SOs that manage and invest funds generally are not considered to be functionally integrated, but there is an exception for SOs that support a single governmental entity. In addition, a Type III SO that serves as the parents of its supported organization is considered to be functionally integrated. Finally, each taxable year, a Type III SO must provide to each of its supported organizations a written notice identifying the SO and describing the amount and type of support it provided to the supported organization during the prior year, a copy of the SO's most recently filed Form 990, and a copy of the SO's governing documents. There are transitional rules for pre-1970 trusts, as well as other transition rules. The proposed regulations are effective as of the date of publication of final or temporary regulations. Comments are being accepted through December 23, 2009. The proposed regulations may be viewed at http://edocket.access.gpo.gov/2009/pdf/E9-22866.pdf

Law Prior to Pension Protection Act of 2006

Supporting Organizations. Supporting Organizations (SOs) are public charities under section 509(a)(3) by providing support to one or more organizations described in section 509(a)(1) or 509(a)(2) (supported organizations). Under section 509(a)(3), an SO must satisfy an organizational test, an operational test, a relationship test, and a disqualified person control test. The proposed regulations focus primarily on the relationship test.

There are three types of SOs. An SO is "operated, supervised or controlled by" its supported organization (often referred to by practitioners as Type I) if the supported organization appoints at least a majority of the board of the SO. An SO is "supervised or controlled in connection with" its supported organization (often referred to by practitioners as Type II) if at least a majority of the boards of the SO and its supported organization consist of the same persons. An SO is "operated in connection with" its supported organization (often referred to by practitioners as Type III) if the SO satisfies a "responsiveness test" and an "integral part test."

Responsiveness Test. Under the responsiveness test, the SO must be responsive to the needs or demands of the supported organization. The responsiveness test is satisfied if 1) the supported organization appoints or elects one or more of the officers, directors or trustees of the SO; 2) one or more members of the governing body of the supported organization serve as officers, directors, or trustees of, or hold other important offices in, the SO; or 3) the officers, directors, or trustees of the SO maintain a "close continuous working relationship" with the officers, directors, or trustees of the supported organization. In all three cases, the relationship must result in the supported organization having a significant voice in the investment policies of the SO, the timing and manner of making grants, the selection of the grant recipients of the SO, and direction over the use of the income and assets of the SO.

There is an alternative means for charitable trusts to satisfy the responsiveness test: 1) the trust is a charitable trust under state law; 2) each supported organization is a named as a beneficiary under the trust's governing instrument; and 3) each beneficiary organization has the power to enforce the trust and compel an accounting under state law.

If an SO was supporting more than one organization before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship also may be taken into account to establish compliance with the responsiveness test.

Integral Part Test. Under the integral part test, the SO must maintain a significant involvement in the operations of one or more supported organizations that are dependent upon the SO for the type of support it provides. The integral part test is satisfied if the SO meets either 1) the "but for" test or 2) the attentiveness test. To meet the "but for" test, the SO must engage in activities that "but for" the SO would be engaged in by the supported organization itself. To meet the "attentiveness test," the SO must 1) make payments of substantially all of its income (85%) to or for the use of one or more supported organizations; 2) provide enough support to one or more supported organizations to ensure the attentiveness of such organizations to the SO; and 3) pay a substantial amount of the total support of the SO to those supported organizations that meet the attentiveness requirement.

The Pension Protection Act of 2006

1. For the first time, the types of SOs are statutorily defined as Type I, Type II and Type III, and Type III SOs are further categorized into two types: functionally integrated and non-functionally integrated.

2. "Functionally integrated" Type III SOs are defined as those that are not required, under regulations established by the Secretary, to make payments to supported organizations due to the activities of the organization related to performing the functions or, or carrying out the purpose of, such supported organizations.

3. The Secretary of the Treasury must set a new payout requirement for "non-functionally integrated" Type III SOs (those organizations that meet the integral part test by satisfying the attentiveness test rather than the "but for" test) to ensure that such organizations pay a "significant amount" to their supported organizations.

4. Type III SOs organized as charitable trusts can no longer satisfy the responsiveness test by showing that they are enforceable by their charitable beneficiaries under state law (the "alternative test" for charitable trusts).

5. Type III SOs must annually provide to each of its supported organizations such information as the Secretary may require to ensure that the SO is responsive to the needs or demands of its supported organizations.

6. Type I or Type III SOs cannot accept a gift or contribution from a person who together with certain related persons, directly or indirectly controls the governing body of a supported organization of the Type I or Type III SO.

7. Type III SOs cannot support organizations organized outside of the United States

8. The private foundation excess business holdings rules apply to non-functionally integrated Type III SOs; there is a transitional rule to allow such SOs additional time to comply.

Advanced Notice of Proposed Rulemaking (August 2, 2007)

1. A Type III functionally integrated SO must meet not only the “but for” test but also two additional tests – an expenditure test and an asset test.

2. A Type III non-functionally integrated SO must distribute 5% of the FMV of its non-exempt-use assets.

3. A Type III non-functionally integrated SO cannot support more than five organizations. Existing SOs that support more than five organization may continue to do so only if the SO distributes at least 85% of its total required payout amount to, or for the use of, supported organizations to which the SO is responsive.

4. All Type III SOs organized as charitable trusts will be required to meet the responsiveness test (applicable as of August 17, 2007 to trusts already in existence).

5. The proposed regulations will provide rules for the form, content and timing of information that Type III SOs are required to provide to their supported organizations.

6. What transitional rules are necessary?

Proposed Regulations (September 23, 2009)

Comments accepted for 90 days.

1. *Notification Requirements.* Each taxable year, a Type III SO must provide to each of its supported organizations: a) a written notice addressed to a principal officer of the supported organizations identifying the SO and describing the amount and type of support it provided to the supported organization in the past year; b) a copy of the SO’s most recently filed Form 990 (or other return required to be filed under federal tax law); and c) a copy of the SO’s governing documents, including any amendments (copies of governing documents need only be provide once). Requirements may be met by electronic media, but the SO must have

proof of delivery. Information must be provided by the end of the fifth month after the close of its tax year.

2. *Responsiveness Test for Charitable Trusts.* All Type III SOs (including charitable trusts) must meet the responsiveness test. No special rule for trusts.

    a. The proposed regulations retained the transitional rule allowing organizations that were operating before November 20, 1970 to qualify as Type III SOs: additional facts and circumstances, such as an historic and continuing relationship with a supported organization, may be taken into account in establishing compliance with the responsiveness test.

3. *Functionally Integrated Type III SO.* A Type III SO is "functionally integrated" if it either a) engages in activities *substantially all* of which *directly* furthers the exempt purposes of the supported organizations to which it is responsive by performing the functions of, or carrying out the purposes of, such supported organization and that, but for the involvement of the SO, would normally be engaged in by the supported organizations, or b) is the parent of each of its supported organizations (parent: exercises a substantial degree of direction over the policies, programs, and activities of the supported organization, and the majority of the officers, directors or trustees of the supported organization must be appointed or elected, directly or indirectly, by the officers, governing body or members of the governing body of the SO).

    a. Further guidance is provided on the types of activities that are considered to "directly further" the exempt purposes of a supported organization. Holding title to and managing exempt use property are considered to so directly further, but fundraising, investing and managing non-exempt-use property and making grants are not.

    b. Exception for SO that supports a single governmental entity—it may treat investing and managing non-exempt-use assets as activities that directly further an exempt purpose, so long as a substantial part of the SO's total activities directly further the exempt purposes of such governmental entity.

    c. The SO's activities must directly further the exempt purposes of those supported organizations with respect to which the SO meets the responsiveness test.

    d. The expenditure and assets tests contemplated by the ANPR were eliminated.

4. *Non-functionally Integrated Type III SO.* A Type III SO is “non-functionally integrated” if it distributes 5% of the FMV of non-exempt-use assets.

    a. The five organization limit of the ANPR was not adopted.

    b. A new SO is not required to distribute any amount in its first year of existence.

    c. Existing SOs will be given a two-year transition rule to come into compliance with the distribution requirement.

    d. The regulations generally draw from the regulations under section 4942 for principles of valuation, timing and carry-overs.

    e. But the proposed regulations do not permit set-asides to count toward the distribution requirement, and the ordering rule for carryovers of excess distributions is reversed. Any excess amount carried forward count first toward the distributable amount, followed by amounts paid out in the later year.

    f. There is a reasonable cause exception for failure to meet the distribution requirement: 1) the failure was due solely to an incorrect valuation of assets, a ministerial error, or unforeseen events or circumstances beyond the SO’s control; 2) the failure was due to reasonable cause and not willful neglect; and 3) the distribution requirement is met within 180 days after the date the incorrect valuation or ministerial error was or should have been discovered, or 180 days after the organization is first able to make its required payout notwithstanding the unforeseen event or circumstances.

    g. The Service may provide by publication in the Internal Revenue Bulletin for a temporary reduction in the annual distributable amount in the case of a disaster or emergency.

5. *Non-functionally Integrated Type III SO/Attentiveness Test.* In addition to the distribution requirement, the SO must distribute at least 1/3 of the distributable amount to one or more supported organizations that are attentive to the SO and with respect to which the SO meets the responsiveness test.

    a. To demonstrate that a supported organization is attentive, a SO must either 1) provide 10% or more of the supported organization’s total support, 2) provide support that is necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization; or 3) provide an amount of support that based on all the facts and circumstances is a sufficient part of a supported organization's total support.

b. Distributions to a donor-advised fund in and of itself will not cause the sponsoring organization of the donor-advised fund to be attentive to the SO.

6. *Transitional Rule for pre-1970 trusts.* Certain trusts created before November 20, 1970 may meet the integral part test by meeting certain requirements in existing Treas. Reg. section 1.509(a)-(4)(i)(4). This test allows such trusts to bypass the distribution and attentiveness requirements, but classifies them as non-functionally integrated Type III SOs for all other purposes.

7. *Excess Business Holding Rules.*

   a. The transitional rules for Type III non-functionally integrated SOs also applies to organizations previously classified as Type III SOs but were re-classified as private foundations as a result of the Pension Protection Act.

   b. Charitable trusts that meet the exception from the integral part test for trusts established before November 20, 1970 are exempt from the excess business holding rules.

8. *Transition Rules.*

   a. The proposed regulations will become effective on the first day of an organization's taxable year that begins after the date when the rules are published in the Federal Register as final or temporary regulations.

   b. Organizations previously classified as Type III SOs under the "but for" test of the existing regulations will be treated as functionally integrated Type III SOs until the proposed regulations are effective. Such organizations must meet the new requirements by the first day of their first taxable year beginning after the date when the final or temporary regulations are published.

   c. Organizations previously classified as Type III SOs under the "substantially all income" test of the existing regulations will be treated as non-functionally integrated until the proposed regulations are effective. Such organizations must meet the new requirements by the first day of their second taxable year beginning after the date when the final or temporary regulations are published, except that the first year after the final or temporary regulations are published must be used to value the organization's assets and the mandatory distributions must commence in the second year based on those values. The distributable amount for the first tax year after publication of final or temporary regulations will be zero.

d. After the proposed regulations are published as final or temporary regulations, an organization that was previously classified as a Type III SO but fails to meet the requirements of the proposed regulations will be classified as a private foundation for the taxable year in which it fails such requirements and all subsequent tax years.

Final Regulations Under Section 2053 Governing Estate Tax Deductions for Administration Expenses and Claims Against Estates

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1. <u>Brief Summary of Major Changes in Final Regulations</u>. Final regulations (effective for decedents dying after October 19, 2009) continue the general concept in the proposed regulations of allowing an estate tax deduction under §2053 for nonascertainable or contingent claims only when they are actually paid. Some of the major changes made in the final regulations include: (1) Exceptions are allowed for contingent claims against an estate to offset the value of other assets that comprise at least 10% of the gross estate and for the deduction of contingent claims totaling no more than $500,000 (although these exceptions may not be widely used); (2) Settlements do not have to be proven to be within the reasonable range of settlement outcomes to be recognized; (3) There is no affirmative duty for the executor to report when claimed expenses or claims are not actually paid; (4) Marital or charitable deductions do not have to be reduced on the return by contingent expenses or claims that may be paid out of amounts that would otherwise pass to a spouse or charity if a protective claim for refund is filed regarding that contingent expense or claim; (5) The rebuttable presumption that claims by family members, related entities or beneficiaries are not legitimate and bona fide has been deleted and a non-exclusive list of factors provided for determining whether a claim by such a person is bona fide; and (6) The concept of allowing only the *present value* of recurring noncontingent claims has been dropped, but a regulation project considering how present value concepts should be applied to §2053 administration expenses and claims is continuing. In addition, Notice 2009-84 issued in conjunction with the regulations clarifies that the IRS will review only evidence related to a §2053 expense or claim in considering a protective claim for refund under §2053 if the claim for refund "ripens" after the three-year period for assessment of additional estate taxes has run.

2. <u>Case Law Regarding Deduction for Claims Against Estates (Now Governing Estates of Decedents Dying Before October 20, 2009)</u>. One possible debt deduction is for claims against the estate that are uncertain in amount at the date of death. There is a split among the circuit courts of appeal on this issue. Aghdami, <u>Effect of Post-Mortem Facts On Claims Against the Estate</u>, TR. & EST. 18 (May 2004); Loeb, <u>Crossed Circuits on Estate Tax Deductibility of Disputed or Contingent Claims</u>, 12 CALIF. TR. & ESTS. Q. 6 (Summer 2006). Older cases in the First, Second, Fifth, and Eighth Circuits have considered post-death events in valuing uncertain claims. The line of cases on the opposite side strictly follow the 1929 Supreme Court decision in <u>Ithaca Trust Co. v. U.S.</u>, 279 U.S. 151 (1929), and its general rule that post-death events must not be considered in valuing the amount of the deduction, because so far as possible, the estate must be settled as of the date of the testator's death. Cases in the Fifth, Ninth, Tenth, and Eleventh Circuits now agree in refusing to consider post-death events in valuing claims against the estate of uncertain value at the date of death.

   Observe that ignoring post-death events can also benefit the IRS in some circumstances. For example, one attorney reported having an estate audit over property worth $700,000 with known environmental problems and reported on the Form 706 an estimated value net of the clean up costs of $250,000. Within two years after the date of death, the estate had actually spent $2.5 million of clean up costs. The IRS objected to considering the actual expenditure.

   A practical problem is how to balance estate tax reporting with the defense of the actual litigation. The plaintiff suing the estate may depose the executor the day after the estate tax return is due and subpoena a copy of the return. If the claim against the estate is reported at a high value on the estate tax return (to support a large deduction), the plaintiff will use that as "Plaintiff's Exhibit 1" to argue that even the estate thinks the claim is valid and large. The best approach seems to report the claim against the estate on the Form 706 and list its value as "Undetermined."

3. Valuation of Disputed Claims Against Estate and Other Administration Expenses — Regulations Effective For Decedents Dying After October 19, 2009. The IRS issued proposed regulations in April 2007, taking the general approach that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate, but there is an exception for estimated amounts that are ascertainable with reasonable certainty. A protective claim for refund can be filed before the statute of limitations runs on refunds, and a deduction is allowed when the claim is resolved and paid. Final regulations were issued effective for decedents dying after October 19, 2009.

a General Rules Applicable to All of §2053, §20.2053-1.

(1) Applies to All of §2053. Regulation §20.2053-1 applies to all deductions under §2053, not just claims against the estate.

(2) Bona Fide Expenses and Claims; Claims by Family Members, Related Entities or Beneficiaries, §20.2053-1(b)(2). A deduction is allowed only for bona fide expenses and claims other than essentially donative transfers ("a mere cloak for a gift or bequest"). Treas. Reg. §20.2053-1(b)(2)(i).

Claims by a family member of the decedent, a related entity, or a beneficiary of the decedent's estate or revocable trust must be "bona fide" to be deductible. The final regulations drop a rebuttable presumption in the proposed regulations that claims by such persons are not legitimate and bona fide. There is a definition of family members, including the decedent's spouse, grandparents, parents, siblings, lineal descendants, and spouses and lineal descendents of grandparents, parents and siblings. [Observe: Spouses of such lineal descendents are not included.] A related entity is an entity in which the decedent, either directly or indirectly, had a beneficial interest at the date of death or in the preceding three years, other than a publicly-traded entity or a closely held entity in which the interests of the decedent and family members is less than 30% (whether voting or nonvoting).

The final regulations add a non-exclusive list of factors that may be considered in determining that such a claim is bona fide. Those factors include whether the claim is: (i) In the ordinary course of business; (ii) Not related to an expectation of inheritance; (iii) Founded on an agreement substantiated by contemporaneous evidence; (iv) Supported by actual performance of the agreement that can be substantiated; and (v) Supported by consistent reporting of such amounts for income and employment tax purposes. (There is an example for accounting services provided by a niece that are so clearly legitimate that the example gives little guidance of how the limitations would be applied in a more non-commercial setting. Treas. Reg. §§20.2053-1(b)(2)(ii-iii) & 20.2053-1(b)(4)Ex.3.)

(3) Court Decree, §20.2053-1(b)(3). The regulations restate the general discussion in the prior regulations regarding the effects of court decrees. The mere payment of funeral expenses, administration expenses, claims or mortgages is not, by itself, sufficient to assure the deductibility of the amount paid. While a court decree is not required to support a deduction (unless a court decree is required under applicable law), the regulation adds that a court decree may be relied on if: (a) the expenditures are otherwise deductible under §2053 and its regulations; (b) the court actually passed on the facts relating to the expenditures and actually passed on the merits of the claim (which is presumed if there is an active and genuine contest, but if the result appears unreasonable, that is "some evidence" that there

was not an active and genuine contest); and (c) the expenditures have been paid or will be paid by the estate. An example in the regulations clarifies that the court's decision must be consistent with local law. Treas. Reg. §20.2053-1(b)(4)Ex.1

If the court decree is based on consent of the parties, the consent must resolve "a bona fide issue in a genuine contest" [deleting the following parenthetical in the prior regulations — "(and not a mere cloak for a gift)"]. The regulation restates a similar provision in the prior regulation that "[c]onsent given by all parties having interests adverse to that of the claimant will be presumed to resolve a bona fide issue in a genuine contest." Treas. Reg. §20.2053-1(b)(3)(iii).

(4) Settlements, §20.2053-1(b)(3)(iv). A settlement may be relied on to support the deduction of an amount paid (or meeting the requirements for ascertainable expenses described below) if several requirements are met: (a) the settlement resolves a bona fide issue in an active and genuine contest; (b) the settlement is the product of arm's length negotiations by parties having adverse interests with respect to the claim; and (c) the underlying claim is not unenforceable. The final regulations drop a requirement in the proposed regulations that the settlement be within the range of reasonable outcomes under applicable state law governing the issues resolved by the settlement, (which might have led to substantial "second guessing" by IRS agents of the settlement decision). Despite dropping that requirement, the final regulations add that "a deduction will not be denied for a settlement amount paid by an estate if the estate can establish that the cost of defending or contesting the claim or expense, or the delay associated with litigating the claim or expense, would impose a higher burden on the estate than the payment of the amount paid to settle the claim or expense." Apparently, that sentence relates to showing the existence of arms' length negotiations; otherwise the regulation does not allow the IRS to address the substance of the settlement (but unenforceable claims may not be deducted despite any settlements).

Observe, if all family members agree with the validity of a claim by another family member, they may have difficulty establishing the arm's length requirement for settlements. That requirement does not exist for the court decree provision (even a court decree based on consent), so the parties may wish to go through a court proceeding rather than just relying on a settlement agreement.

(5) Limit to Amounts Actually Paid (and Not Reimbursed), §20.2053-1(d)(1). A sentence is added to this regulation limiting all deductions under §2053 (including funeral expenses, executor commissions, attorney fees, administration expenses, and mortgages) to "the total amount actually paid." A corollary of this requirement is that no deduction is allowed if the amount "is or could be compensated for by insurance or otherwise." The final regulations add that an executor may certify on the return that the executor "neither knows nor reasonably should have known of any available reimbursement." §20.2053-1(d)(3). (Query, how can the executor certify on the return what he "reasonably should have known?") A potential reimbursement will not reduce the deduction if the executor provides a reasonable explanation of why the burden of collection efforts would outweigh the anticipated benefit. Observe: Being able to consider the "burden" of collections is considerably broader than just considering the "expenses" of collection.

(6) Ascertainable Amounts, §20.2053-1(d)(4). The regulation keeps the concept in the prior regulation that allows the deduction of estimated amounts that are ascertainable with reasonable certainty (as opposed to vague and uncertain estimates) and will be paid, even if the exact amount is unknown. The final regulation adds that executor commissions and attorney fees that meet the general requirements for deductibility (under Regulation §20.2053-3(b-c)) "are deemed to be ascertainable with reasonable certainty and may be deducted if such expenses will be paid." Treas. Reg. §20-2053-1(d)(4)(i).

If an amount cannot be ascertained with reasonable certainty, no deduction is allowed until the amount is paid. Treas. Reg. §20.2053-1(d)(4)(i). (There are several additional exceptions, described below, for uncertain claims against an estate.) Post-death events are taken into account in determining the amount that is "ascertainable with reasonable certainty and will be paid." Treas. Reg. §20.2053-1(d)(4)(ii).

If the tax preparer has any doubt whether an amount that is unpaid at the time of filing is "ascertainable with reasonable certainty," then the preparer should file a protective claim. If the IRS disallows the deduction, the protective claim will generate a deduction of the amount that is actually paid.

(7) No Affirmative Duty to Report. The proposed regulation added that the executor has the duty to notify the IRS if the payment is waived or left unpaid, and must pay the resulting additional estate tax (with interest). (Observe: that requirement was in the prior regulation dealing with executor commissions, §20.2053-3(b)(1).) The final regulation deletes the affirmative duty to report. The preamble to the final regulations noted that "[s]ome commentators questioned whether the proposed regulations would impose a duty on the executor to report amounts that were claimed as deductions on the estate tax return, but were subsequently not paid or not paid in full, and whether such a duty could be enforced after the period of limitations on assessment has expired." The preamble's response is that "[t]he Treasury Department and the IRS did not intend for the proposed regulations to impose a duty on the executor that could be enforced after the expiration of the period of limitations on assessment," and the final regulations eliminate the duty to report provision altogether. (Indeed, the final regulations eliminate the duty to report as to executor commissions that was in the prior regulation. Treas. Reg. §20-2053-3(b)(1).).

(8) Protective Claims for Refund, §20.2053-1(d)(5).

(a) Timing. The protective claim for refund may be filed at any time within the period of limitations for filing a claim for refund under §6511(a) (i.e., the later of three years after the return was filed or two years after the payment of tax). (While there is an extended period of time to file the protective claim for refund, many planners recommend filing it at the same time as the Form 706, or very soon thereafter, to assure that the filing deadline is not later missed inadvertently.)

(b) Identification of Claims. The protective claim for refund must identify each claim or expense and describe the reasons and contingencies delaying actual payment of the claim. (Amounts do not have to be listed.)

(c) Consideration of Protective Refund Claim. The protective claim for refund is considered after the executor has notified the IRS "within a reasonable period that the contingency has been resolved." While no specific time period is specified beyond "reasonable period," the executor cannot delay raising the protective claim with the IRS indefinitely after the contingency has been resolved.

(d) Further Guidance. The preamble to the final regulations indicates that the IRS will issue further guidance on the process of using protective claims for refund. The preamble also indicates that the IRS is considering amending Form 706 to incorporate a protective claim for refund so that a separate form need not be filed.

(e) Notice 2009-84: Entire Return Not Open to Offset Protective Refund Claim. The Supreme Court has held that the IRS can examine each item on a return to offset the amount of a refund claim, even after the period of limitations on assessment has run. Lewis v. Reynolds, 284 U.S. 281, 283 (1932). However, the IRS in Notice 2009-84 agreed that it would limit the review of protective claims for refund to preserve the ability to claim a deduction under §2053 "to the evidence relating to the deduction under section 2053," and not exercise its authority to examine each item on the return to offset a refund claim. This limitation does not apply if the IRS is considering a claim for refund not based on a protective claim regarding a deduction under §2053 in the same estate. Also, the limitation applies "only if the protective claim for refund ripens after the expiration of the period of limitations on assessment and does not apply if there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact." (Accordingly, there may be an advantage in not having resolved the underlying lawsuit regarding the claim against the estate until after the period on additional assessments has run — to the extent that there may be items on other parts of the estate tax return that the IRS might question if it could.)

(f) Effect on Marital or Charitable Deduction. The possibility of a contingent claim against an estate will not reduce the amount of marital or charitable deduction available on the estate tax return even if the contingency is payable out of a marital or charitable share. (This applies under the regulation only "to the extent that a protective claim for refund is filed." Presumably, the IRS anticipates that returns will not need to reduce the marital or charitable deduction even before the protective claim for refund has been filed.) However, after the contingency is resolved and the amount is paid, the marital or charitable deduction will be reduced (but generally would be offset by the §2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii).

b. Executor Commissions and Attorney Fees, §20.2053-3(b-d). Executor commissions are deductible only if they are within the usually accepted standards and practice for estates of similar size and character. Any deviation from the usually accepted standards or range of amounts (permissible under applicable local law) must be justified to the Commissioner. If the decedent's will sets the amount of executor's commissions, they can be deducted to the extent the amount does not exceed the amount allowable by local law or practice. Treas. Reg. §20.2053-3(b). Attorneys' fees may not be deducted if they exceed a reasonable amount considering the size and character of the estate, the law and practice in the jurisdiction, and the skill and expertise of the attorneys. A deduction for reasonable attorneys fees in contesting an asserted deficiency or in pursuing a claim for refund may be allowed even if not claimed on the return or in the claim for refund. Treas. Reg. §20.2053-3(c)(1-2). Expenses in defending against claims against an estate are deductible even if the estate does not prevail. Treas. Reg. §20.2053-3(d)(3).

c. <u>Claims Against the Estate, §20.2053-4</u>. The one short paragraph in the prior regulations has been expanded to pages of detailed provisions regarding the deductibility of claims against the estate.

(1) <u>General Requirements</u>. Deductible claims are limited to bona fide claims that —

(i) Represent personal obligations of the decedent existing at the time of the decedent's death;

(ii) Are enforceable against the decedent's estate (and not unenforceable when paid); and

(iii) Are actually paid by the estate in satisfaction of the claim or are ascertainable. Treas. Reg. §20.2053-4(a)(1).

Post-death events are considered. Treas. Reg. §20.2053-4(a)(2).

Executors must be very diligent and not pay unenforceable claims. Sometimes executors pay unenforceable claims — because it is the "right" thing to do or the executor may not realize the technical unenforceability. For example, maybe creditors did not follow the technical rules for presentment of claims. If the executor pays that claim, it is not deductible. As another example, if the statute of limitations has run on a note that a family member holds, the estate should not pay it.

(2) <u>Potential and Unmatured Claims; Contested Claims, §20.2053-4(d)(1-2)</u>. No deduction may be taken on an estate tax return for a potential or unmatured claim or for a contested claim, but the estate can file a protective claim for refund, so that unmatured claims that later mature and are paid are deductible.

(3) <u>Exceptions</u>.

(a) <u>Claims and Counterclaims in Related Matter, §20.2053-4(b)</u>. If the estate includes a claim or cause of action or other particular asset and there is a claim against the estate in the same matter or that is "integrally related to that asset," the claim may be deducted on the estate tax return if the claim meets the other requirements for deducting administration expenses other than the "reasonably ascertainable" requirement and if (i) the value of the claim is determined from a "qualified appraisal" by a "qualified appraiser" (using the rules under §170(f)(11)(E)) and (ii) the aggregate value of the related claims or assets included in the gross estate exceed 10 percent of the gross estate. The claim may be deducted only up to the value of the related claim or asset value. The value of the claim is subject to adjustment for post-death events. Treas. Reg. §20.2053-4(b)(3).

(b) Claims Totaling Not More Than $500,000, §20.2053-4(c). The estate may deduct any non-ascertainable claims (that meet the other general requirements for deductions under §2053) that have a combined value up to $500,000 (in addition to claims that can be deducted under the "counterclaim exception" described above). However, the "full value" of each such claim must be within the aggregate $500,000 limit for the estate. For example if there are three claims against the estate valued at $200,000 each, two of the claims could be deducted under this exception, but not the third claim because the full value of the third claim would not be covered by the $500,000 limit. Treas. Reg. §20.2053-4(c)(3)Ex. 2. As with the "counterclaim exception," there must be a qualified appraisal by a qualified appraiser of each such claim deducted under this exception, and the value of the claim is subject to adjustment for post-death events.

(c) Practical Effect of Exceptions. Notice 2009-84, issued in conjunction with the release of the final regulations to §2053, state that "[a]s a result of these exceptions, the Treasury Department and the Service anticipate that the number of protective refund claims filed to preserve a deduction under section 2053 will be significantly smaller that was anticipated by commentators to the proposed regulations." However, few estates may elect to use these two exceptions. Planners generally recommend not taking an estate tax deduction for non-ascertainable claims while litigation is still ongoing or threatened for fear the value placed on the estate tax return would be used in the underlying substantive litigation. This fear would be exacerbated if the return not only places a value on the claim but also is supported by a "qualified appraisal." Furthermore, it may be difficult to find "qualified appraisers" who have the expertise to value contingent claims in litigation. In the past, trial attorneys or judges with substantial experience in litigating claims have been used at trial to support the date of death estimated value of claims against an estate. In many situations, they would seem to have the best experience in evaluating such claims in litigation, but they probably do not meet the detailed requirements of a "qualified appraiser" under §170(f)(11)(E)(ii) (i.e., they probably do not have an appraisal designation from a recognized professional appraiser organization or regularly perform appraisals for which they receive compensation).

(4) Multiple Parties; Reimbursement, §20.2053-4(d)(3). If the claim is asserted against the estate and one or more other parties, only the portion "due from and paid by the estate" may be deducted. The deductible portion must be reduced by any reimbursement received from any other party or the amount the estate could collect from another party or insurer even if the estate declines or fails to attempt to collect. (Presumably, a failure to pursue reimbursement will not reduce the deduction if the burden of collecting from others "would outweigh the anticipated benefit from those efforts," but unfortunately, the regulation seems to mistakenly cross reference the wrong paragraph of Treas. Reg. §20.2053-1 (and not the paragraph dealing with reimbursements).)

(5) Unenforceable Claims, §20.2053-4(d)(4). Claims that are unenforceable prior to death or before they are actually paid are not deductible, even though the estate pays the claim.

(6) Claims Founded on a Promise, §20.2053-4(d)(5). The prior regulation says that claims founded on a promise or agreement or deductible only if the promise or agreement was "bona fide and in exchange for adequate and full consideration." The final regulation also requires that "the promise or agreement must have been bargained for at arm's length and the price must have been an adequate and full equivalent reducible to money value."

(7) Recurring Payments and Present Value Concepts, §20.2053-4(d)(6). The proposed regulations provided that only the date of death (or alternate valuation date) present value of recurring noncontingent obligations (such as an obligation under a divorce decree to make alimony payments) could be deducted under §2053. The present valuing concept does not apply for contingent payments after the contingency is resolved — the actual amount of those payments can be deducted in full without any present value limitation. To be consistent, the IRS dropped the present value limitation for recurring noncontingent obligations in the final regulations, and they can be deducted in full on the return. A claim subject to a contingency related to death or remarriage is still treated as a noncontingent claim for this purpose, although the death or remarriage contingency would be considered in determining the value of the claim using "factors set forth in the transfer tax regulations or otherwise provided by the IRS." Treas. Reg. §20.2053-4(d)(6)(i) & 20.2053-4(d)(7)Ex. 8. (Query, will the IRS supply remarriage factors? Example 8 suggests that it will.)

The preamble to the final regulations notes that the Treasury and IRS believe that the appropriate use of present value in determining §2053 deductions merits further consideration, and there is an ongoing project on the Treasury Priority Guidance Plan for that issue.

If a commercial annuity is purchased from an unrelated dealer to satisfy a recurring obligation on an enforceable and certain claim (whether or not contingent), the estate can deduct the sum of (a) the amount paid for the commercial annuity, (b) any amount actually paid prior to the purchase of the commercial annuity, and (c) any additional amount in excess of the annuity amount necessary to satisfy the recurring obligation. Treas. Reg. §20.2053-4(d)(6)(iii).

(8) Interest on Claims, §20.2053-4(e). The interest accrued up to the date of death and actually paid on a claim is deductible as a claim. (The date of death amount applies even if the estate elects the alternate valuation date for purposes of valuing assets.)

"Post-death accrued interest may be deductible in appropriate circumstances either as an estate tax administration expense under section 2053 or as an income tax deduction."

d. Taxes, §20.2053-6, 20.2053-9, 20.2053-10. The regulations are updated to refer to the deductibility of state estate taxes for decedents dying after 2004 under §2058. The regulations also add a provision clarifying that a deduction for taxes is allowed for any post-death adjustments increasing a tax [such as gift or income tax] and allowing a protective claim for refund to keep the statue of limitations open to make such a claim. Treas. Reg. §20.2053-6(g). Similarly, any refund subsequently determined and paid after the date of death will reduce the deduction "upon examination by the Commissioner." (The final regulations omit an affirmative duty to report the refund to the IRS that appeared in an example in the proposed regulations. Treas. Reg. §20.2053-6(g)Ex.2.)

e. Practical Considerations for Completion of Form 706 and Form 843. On the Form 706, the nature of the claim against the estate (and counterclaims) should be described. Give the IRS examiner an idea of how big the claim is or could be. Many attorneys list "Value Undetermined" in the value column on form 706 rather than zero. Putting zeros on the estate tax return might conceivably be argued as an admission against interest.

An example Form 843 proposed by Ann Burns suggests the following example description: "This protective claim for refund is filed pursuant to Treas. Reg. §20.2053. The decedent is a defendant in a suit by John Smith and Mary Jones for breach of contract. Decedent has filed a counterclaim based in fraud. The amount claimed against the decedent is $xxxx. The amount of the counterclaim is $xxxx. Cross motions for summary judgment have been filed and a decision of the court is pending." Cathy Hughes suggests also adding a reference to the related item number on Schedule K of the Form 706.

The problem is even worse if the estate owns a claim against another party. The executor will have to take a position on the estate tax return as to the value of the asset. Even if the executor lists the value as "uncertain" on the estate tax return, the issue will be addressed in the audit, and it is more likely that the attorney defending the claim will be able to discover the negotiated value than in the case of a claim against the estate, for which a deduction can just be delayed until after the underlying claim is resolved.

If a claim owned by the estate that is in litigation has a significant value, the estate should be able to obtain an extension of time to pay under §6161. Treas. Reg. §20.6161-1(a)(1)Ex.(3). Estate tax extensions are granted for 12 month intervals for up to 10 years. Subsequent extensions are generally more difficult to obtain than the initial extension because the IRS wants to make sure that executors move promptly to pay their taxes, but if an asset is tied up on litigation, as a practical matter the IRS will likely just ask for a status update. *See* Internal Revenue Manual §§ 5.5,5.2, 5.5.5.3.

f. New Regulation Project Considering Applying Present Value of Administration Expenses and Claims; Graegin Loans. The proposed regulations do not seem to impact Graegin loans at all. While Regulation §20.2053-1(d)(1) limits §2053 deductions to amounts actually paid, Regulation §20.2053-1(d)(4) allows the deduction of estimated amounts that are ascertainable with reasonable certainty. The prior and final regulations both allow a deduction of estimated amounts of administration expenses that may be ascertained with reasonable certainty and will be paid. Prior Reg. §20.2053-1(b)(3); Final Reg. §20.2053-1(d)(4).

The Treasury Priority Guidance Plan for 2009 includes a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys fees, Tax Court litigation expenses, etc.). Graegin notes are also in the scope of that project. The final regulations confirm that the project is continuing and reserves §20.2053-1(d)(6) for further guidance on this issue.

Estate of Christiansen v. Commissioner, 104 AFTR2d 2009-XXXX (8th Cir. Nov. 13, 2009, corrected Nov. 18, 2009)

Eighth Circuit Upholds Formula Disclaimer Over Public Policy Objections (or "Friday the 13th Massacre of IRS Position on Defined Value Clauses")

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Synopsis

In a "Friday the 13th" decision, the Eighth Circuit Federal Court of Appeals dealt a crushing blow to the IRS's position of refusing to recognize "defined value" types of clauses. In Estate of Christiansen, a sole beneficiary disclaimed all of the estate (under a fractional formula) in excess of $6,350,000. The disclaimed assets passed 75% to a charitable lead annuity trust ("CLAT") and 25% to a foundation. The IRS and the estate agreed to increase the value of the gross estate from $6.5 to $9.6 million. The Tax Court held that the disclaimer as to the 75% that passed to the CLAT did not satisfy all the technical disclaimer requirements (so the estate owed estate tax on that portion of the increase value of the estate). The estate did not appeal that aspect of the case. As to the 25% that passed to the foundation, the technical disclaimer problem did not exist, and the IRS argued that a charitable deduction should not be permitted for the increased value for two reasons. First, any increased amount passing to the charity was contingent on future events in violation of a charitable deduction regulation. Second (and more importantly in the broader planning context), the transfer violates public policy because it reduces the IRS's incentive to audit estate tax values. The Eighth Circuit rejected both of the IRS's arguments. Many of the reasons for rejecting the public policy reasons apply generally to certain types of defined value clauses.

The case is especially important because of its implications for defined value transfers, such as (1) a transfer that is made and allocated between a "taxable" and "non-taxable" portion based on gift or estate tax values or based on agreement of the parties, or (2) a transfer in which the amount transferred is defined by a formula referring to gift or estate tax values. A redetermination of value by the IRS operates much like under a standard marital deduction formula clause, where an increased value allocates a larger value to the surviving spouse but does not generate additional estate tax. A major uncertainty has been whether courts will uphold inter vivos defined value transfers against a public policy attack (even though standard marital deduction formula clauses in wills have operated in that same manner for decades). This case appears to be a bellwether case in leading the way to upholding defined value transfers despite attacks by the IRS on public policy grounds.

Basic Facts

The decedent's will left her entire estate to her daughter. Any disclaimed assets would pass 75% to a CLAT and 25% to a foundation. (Apparently the annuity amount and term were designed so that the present value of the charitable lead interest was equal or almost equal to the full value passing to the trust.) The daughter made a formula disclaimer, in effect disclaiming a fractional share of the estate exceeding $6.35 million, and the estate tax return reflected an estate value of slightly over $6.5 million. The specific formula disclaimer clause provided, in part, as follows:

> "Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton, hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 dollars ($6,350,000) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001…."

The clause went on to define "fair market value" by reference to "as such value is finally determined for federal estate tax purposes."

Under the values as returned, about $120,000 passed to the CLAT and about $40,000 passed to the foundation as a result of the disclaimer. In the estate tax audit, the IRS and the estate agreed to increase the fair market value of the gross estate from approximately $6.5 to $9.6 million. Under the disclaimer, the additional $3.1 (i.e., $9.6 – 3.5) million value all passed to the CLAT and foundation, and if those transfers qualified for the estate tax charitable deduction, there would be *no additional estate tax*. (In this manner, the formula disclaimer operated much like "defined value" transfer clauses designed to define the amount transferred so that there would be no (or minimal) additional gift tax over the intended amount.) The IRS agreed that it would allow an estate tax charitable deduction for the $40,000 that passed to the foundation based on the values reported on the Form 706, but it refused to allow any charitable deduction for the remaining increased value of the estate that passed to charity as a result of the disclaimer.

The Tax Court held that the disclaimer to the CLAT was not a qualified disclaimer due to technical violations of the disclaimer regulations, so no estate tax charitable deduction was allowed for amounts passing to the CLAT under the disclaimer. The estate did not appeal that finding. The Tax Court held that the disclaimer to the foundation did not have any of the technical disclaimer problems and that the disclaimer was not contingent on a subsequent event and did not violate public policy; an estate tax charitable deduction was allowed for the full increased gross estate amount that passed to the foundation under the disclaimer. The IRS appealed that determination.

Holding

The formula disclaimer was recognized and all of the increased value that passed to the foundation qualified for the estate tax charitable deduction. The Tax Court decision was affirmed. (The corrected decision merely made a minor one-word change.)

Analysis

1. Contingent on Subsequent Event Argument Rejected. Treasury Regulation §20.2055-2(b)(1) provides that an estate tax charitable deduction is not available if the charitable transfer is "dependent upon the performance of some act or the happening of a precedent event." The IRS argued that the amount passing to the charity was contingent on the determination of the final estate tax value.

   a. Tax Court. The Tax Court concluded that regulation does not apply because the regulation refers to "a transfer" of property passing to charity, and the *transfer* to the foundation in this case occurred at the time of the disclaimer and is not contingent on any event that occurred after the decedent's death.

      > "That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its existence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future."

   b. Eighth Circuit. The regulation requires the existence of "*a transfer at the date of death;*" not "the existence or finality of an accounting evaluation." The only outstanding issue was valuation, and "[t]he foundation's right to receive twenty-five percent of those amounts in excess of $6.35 million was certain." There is a difference between post-death events that change the actual value of an asset and events that "are merely part of the legal or accounting process of determining value at the time of death." Cases cited by the IRS all involved situations where the actual transfer was dependent on various contingencies (such as a daughter dying without descendents, and a trust that allowed the family beneficiary to invade corpus).

Furthermore, estate tax charitable deduction regulations regarding charitable lead annuity trusts recognize that references to values "as finally determined for Federal estate tax purposes" are sufficiently certain to be considered "determinable" to qualify as a guaranteed annuity interest. Treas. Reg. §20.2055-2(e)(2)(vi)(a). Therefore, references to values "as finally determined for estate tax purposes" are not references that are dependent upon post-death contingencies that might disqualify the availability of a charitable deduction.

2. Public Policy Argument Rejected.

a. IRS Position. "[T]he Commissioner argues that we should disallow fractional disclaimers that have a practical effect of disclaiming all amounts above a fixed-dollar amount. According to the Commissioner, such disclaimers fail to preserve a financial incentive for the Commissioner to audit an estate's return. With such a disclaimer, any post-challenge adjustment to the value of an estate could consist entirely of an increased charitable donation. Because this scenario would provide no possibility of enhanced tax receipts as an incentive for the Commissioner to audit the return and ensure accurate valuation of the estate, the Commissioner argues such disclaimers should be categorically disqualified as against public policy."

b. Recognition of "Marginally" Decreased Incentive. The Eighth Circuit agreed that the disclaimer of all amounts in excess of a fixed-dollar amount "may marginally detract from the incentive to audit estate tax returns." In some situations, that might permit "a charitable deduction equal to the increase in the estate, resulting in no increased estate tax." (However, footnote 2 observed that under the facts of this case, there is no offsetting charitable deduction for the 75% of the increased value that passed to the CLAT.) The IRS's argument is that strategies such as a fixed-dollar amount partial disclaimer that operate to allow an additional deduction to offset any increased value should be disallowed on policy grounds "because of the potential moral hazard or untoward incentive they create for executors and administrators to undervalue estates."

The court gave three reasons, discussed immediately below, for rejecting the IRS's public policy argument even if the effect is that increasing values in audits would not increase the estate tax collected as a result of the audits.

c. IRS's Role Is to Enforce Tax Laws, Not Just Maximize Tax Receipts. "First, we note that the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." **[Observe: This reason applies just as strongly to all defined value clauses.]**

d. No Clear Congressional Intent of a Policy to Maximize Incentive to Audit. "Second, we find no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The relevant policy in the present context is clear, and it is a policy more general in nature than that articulated by the Commissioner: Congress sought to encourage charitable donations by allowing deductions for such donations." **[Observe: This reason only applies to "formula allocation clauses" (described in Item 1 of the "Observations" section below) that "pourover" the excess over a defined value amount to a charity.]**

e. Other Mechanisms Exist to Ensure Values Are Accurately Reported. "The Commissioner premises his policy argument on the assumption that executors and administrators will purposefully undervalue assets in order to take advantage of his marginally decreased incentive to audit. In the present context, however, there are countless other mechanisms in place to ensure that fiduciaries such as executors and administrators accurately report estate values. State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations." (The court cites statutes and cases providing that the personal representative is a fiduciary and that the attorney general has a duty to enforce the rights of charitable foundations). Furthermore, "the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor or administrator does not under-report the estate's value" and serve a "watchdog function." In this case the disclaimant was the executor and a board member of the foundation. Because of her fiduciary obligation, any self-dealing "would be a clear violation of her general state-law fiduciary obligation to put the interests of the foundation above her own interests …"

Conclusion as to this reason: "In general, and on the specific facts of the present case, then, there are sufficient mechanisms in place to promote and police the accurate reporting of estate values beyond just the threat of audit by the Commissioner, thereby undercutting the Commissioner's policy-based argument."

[Observe: References to the attorney general's enforcement of charities' rights would apply only to "formula allocation clauses" with a charity as the "pourover" recipient of the excess value over a described dollar amount. However, the references to the general fiduciary duty of the executor and fiduciary duty of a charitable foundation board member would seem to apply whenever the "pourover" recipient of the excess value under a "formula allocation clause" is a trust.]

Observations

1. General Description of Defined Value Clauses. The major significance of the opinion is not based on the particular fact situation of the case, but that the reasoning of the case rejects the IRS's public policy argument against defined value clauses. A general description of defined value clauses may be helpful to understand the significance of the court's reasoning and of the various observations in this section of the summary.

   There are two general types of defined value clauses.

   a. A "formula transfer clause" limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula).

      An example fractional formula transfer clause (with a provision for a small gift being produced if the IRS asserts higher values for gift tax purposes) is as follows:

      > "I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is (a) $100,000 plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the "Gift Tax Value") over $100,000. The denominator of the fraction is the Gift Tax Value of the property." McCaffrey, Tax Tuning The Estate Plan By Formula, UNIV OF MIAMI SCHOOL OF LAW PHILIP E. HECKERLING INST. ON EST. PL. ¶402.4 (1999).

   b. A "formula allocation clause" allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values. For example, the McCord case used the second type of clause with the allocation being based on a "confirmation agreement" among the transferees.

The IRS primary position is that these types of clauses should be not be recognized for tax purposes on public policy grounds because they reduce the IRS's incentive to audit returns.

2. Extremely Fast Opinion. The oral argument was on September 22, 2009. (John Porter argued this case 20 minutes before arguing the Holman case before the same three-judge panel of the Eighth Circuit.) The opinion was issued a mere seven weeks later on November 13. (A corrected opinion was issued on November 18, merely changing "Christine's death" to "Helen's death" in the fourth paragraph of the opinion.) This seems to suggest that the judges came to their conclusion very quickly with little difficulty in concluding that such clauses are valid and do not violate public policy.

3. Short Concise Pithy Opinion. The entire opinion is only eight pages long (double-spaced, 12 point font). Despite its shortness, it addresses the major issues with a reasoned and thoughtful analysis including various reasons for its conclusions. (This is somewhat embarrassing to the author of this summary — the opinion is significantly shorter than this summary and analysis of the case.)

4. Unanimous Decisions. The Tax Court was unanimous in its analysis of the validity of the portion of the disclaimer passing directly to the foundation (including the public policy issue) and the Eighth Circuit opinion was also unanimous.

5. Devastating Blow to IRS. The IRS must view this as "that Friday the Thirteenth Horror Case." The case affirms the validity of the formula disclaimer, but more importantly, the analysis of the public policy argument seems to apply to defined value clauses generally. The court's first reason for rejecting the "no incentive to audit" argument (i.e., that the IRS has a duty to enforce the tax laws, not just maximize collections) applies with equal force to all defined value clauses. The second reason (regarding Congressional policy favoring charitable transfers) applies to all "formula allocation clauses" having a charity as the "pourover" recipient. The third reason (regarding fiduciary duties) applies to all "formula allocation clauses" where the "pourover" recipients involve one or more trusts or other entities having trusts or board members with fiduciary duties (even if a charity is not involved).

   This case does not resolve all questions about the effectiveness of defined value clauses. The case does not have a direct holding about defined clauses (the facts involve a formula disclaimer not an inter vivos defined value clause), and it just represents the view of the Eighth Circuit. The Fifth Circuit gave effect to a defined value clause in McCord, but it did not directly address the public policy issue. Still, there are now two federal courts of appeal cases that provide support for these clauses. Despite their limitations, these two federal courts of appeals cases seem to pave the way toward recognition of these clauses. It is a devastating blow to the IRS that the first federal court of appeals case in 65 years to consider the public policy issue ruled against the IRS with very broad reasoning that applies to many types of defined value clauses.

6. Brief Historical Background. This case has been eagerly anticipated as the first federal court of appeals case since the Procter case in 1944 (yes, 65 years ago!) to address the public policy issues

of similar types of clauses where the IRS argues that the clauses should be invalidated because they reduce the IRS's incentive to audit returns.

a. Commissioner v. Procter. In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944), a transfer instrument provided that if the federal court of last resort held that any part of the transfer was subject to gift tax, the gift portion of the property "shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created." The Fourth Circuit Court of Appeals concluded that the provision imposed a condition subsequent to the transfer, and that the condition subsequent violated public policy for three reasons, discussed in Item 6 below.

Interesting aside: In Procter, the Fourth Circuit raised the public policy argument on its own. It was not argued by any of the parties.

Several lower court cases have relied on Procter in refusing to give effect to various types of clauses that reduce the IRS's incentive to audit returns. Indeed, prior to McCord and Estate of Christiansen, the trend of the cases has been to support the Procter result. E.g., Ward v. Comm'r, 87 T.C. 78 (1986) (gift with agreement that if finally determined gift tax value was different, the number of shares transferred would be increased or decreased; court construed agreement as power to revoke and expressed concern that if no challenge took place the "excess value" would pass without tax); Harwood v. Comm'r, 82 T.C. 239 (1984), aff'd, 786 F.2d 1174 (9th Cir. 1986) (transfer of limited partnership units with provision that if value finally determined to exceed $400,000 for gift tax purposes, the trustee was to execute a note back to the donor for the "excess value"); Estate of McLendon v. Comm'r, T.C. Memo 1993-459, rev'd, 77 F.3d 447 (5th Cir. 1995) (appellate opinion does not discuss value clause; Tax Court ignored the adjustment clause, based on Procter and Ward, concluding that it would not expend "precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render that issue moot").

b. IRS Position; Revenue Ruling 86-41, Revenue Ruling 86-41, 1986-1 T.C. 300 refused to recognize two different types of valuation adjustment clauses contained in a deed of gift of real estate. The first clause provided that the transferee would reconvey to the transferor a sufficient portion of the real estate to reduce the value of the transferred interest to $1,000 as of the date of the gift. The second clause required that the transferee repay to the transferor an amount equal to the excess of the value of the property over $1,000, as determined by the IRS. The Service rejected both of those provisions as a transfer subject to a condition subsequent.

c. McCord v. Commissioner; Fifth Circuit Gives Effect to Defined Value Clause But Does Not Address Public Policy Argument. McCord involves a gift made by a formula giving specified dollar amounts of limited partnership interests to trusts for children and to charities. 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003). Under an assignment by parents, children and trusts for children were to receive limited partnership interests having an aggregate fair market value of $6,910,933 and the excess was to pass to various charities. The allocation was to be based on a "confirmation agreement" among the transferees. The Fifth Circuit held that the IRS had the burden of proof, and the IRS did not meet its burden of proof to rebut values used by the taxpayers. The values of the transferred interests, for purposes of calculating gift and GST taxes, were the values used by the taxpayers (i.e., $89,505 for a 1% interest). The Tax Court erred in using the confirmation agreement to convert dollar gifts into percentage gifts. Post-gift acts of donees cannot change the value transferred on the date of the gift. The Tax Court should have applied the defined value clause under its plain wording (although the Fifth Circuit stated that the Commissioner chose not to argue the public policy issue and the court did not explicitly consider that issue).

The Fifth Circuit opinion gave no indication whatsoever that the judges viewed the dollar amount assignment as abusive or that it raised "smell test" concerns. To the contrary, the court went out of its way to chide the Tax Court for ignoring the "plain wording" of the dollar value assignment on the basis of its perceived "olfaction." The Fifth Circuit concluded that the Tax Court majority's application of its "smell test" resulted in its failure to give effect to the dollar gifts in the assignment.

7. Procter Distinguished by Tax Court, Not Mentioned by Eighth Circuit. The IRS's position is reminiscent of the 1944 Procter case, in which the Fourth Circuit of Appeals on public policy grounds voided a clause providing that if any part of a transfer is subject to gift tax, the gift portion of the property should automatically be deemed not to be included in the conveyance. Procter cited three reasons: (1) the provision would discourage collection of tax, (2) it would render the court's own decision moot by undoing the gift being analyzed, and (3) it would upset the final judgment. The Tax Court in Estate of Christiansen specifically distinguished the Procter case and determined that the three reasons cited in Procter are not applicable. As to reasons (2) and (3) in Procter, the Tax Court's reasoning seems to apply to defined value clauses generally:

> "This case is not Procter. The contested phrase would not undo a transfer, but only reallocate the value of the property transfer among Hamilton, the Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, the property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case."

Observe that the court's rationale applies word for word to defined value transfers where, for example, property is transferred to a trustee and the defined value clause operates to allocate the property between two separate trusts under the trust agreement.

As to the reference in Procter about reducing the incentive of the IRS to audit returns as a result of the disclaimer clause, the Tax Court reasoned that IRS estate tax audits are far from the only policing mechanism, pointing to the fiduciary duties of executors and directors of foundations, the possible involvement of state attorneys general and even the Commissioner himself if fiduciaries misappropriate charitable assets (by threatening to rescind the charity's tax exemption or by its power to impose intermediate sanctions).

8. Choice of Type of Defined Value Clause. "Formula transfer clauses" are simpler to administer and do not require involving a third party. However, "formula allocation clauses" more squarely fall within the court's rationale for rejecting the public policy argument, including having someone with a fiduciary duty to police the valuation. The Tax Court's reasoning for distinguishing Procter (see Item 6 above) applies more directly to "formula allocation clauses." The first reason for rejecting the public policy argument given by the Eighth Circuit (the "duty to enforce tax laws reason") applies to all defined value clauses, but the second and third reasons only apply to "formula allocation clauses" where someone with an interest that is adverse to a lower valuation can police the clause. The fiduciary duty rationale does not apply as strongly to a "formula transfer clause" even if the recipient is a trust, because the fiduciary has no duty to police that an excessive value is not being transferred to the trust. The example "formula valuation clause"

described in Item 1.a of this Observations section provides that the amount transferred will include 1% of any increased value from a gift tax audit. That provides one rationale for arguing that the public policy objection should not apply (because there is still some incentive to audit the return). However, the second and third reasons given by the Eighth Circuit in Estate of Christiansen for rejecting the public policy argument would not be applicable to that type of clause.

9. Structure "Formula Allocation Clauses" to Require Fiduciary Review of Value Determination. The opinion emphasizes that there are other mechanisms to enforce the valuation determination and to thwart "the potential moral hazard or untoward incentive" these clauses might create for undervaluing transfers, specifically emphasizing the fiduciary duties of the parties involved. In this case, the executor as well as the recipients of the transfer had fiduciary duties. In the typical inter vivos transfer using a defined value approach, the transferor does not have a fiduciary duty, but the *recipients* will have fiduciary duties (if the recipients are trusts) to assure that values are proper and that the trust is receiving its appropriate amount. Indeed, the court's rationale referred to the *disclaimant's* fiduciary duty as executor and board member, suggesting that the reasoning would apply even if the *transferor* under a defined value clause were the fiduciary of a trust "pourover" recipient under a "formula allocation clause." However, a stronger rationale would exist if another party, or better yet an independent entity, serves as the fiduciary.

Department Of Labor Announces Plans To Expand Reporting Employee Benefits, Wage & Hour, OSHA & Other Reporting & Disclosure Requirements & To Implement Other New Employee Benefit Regulations

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The Employee Benefits Security Administration (EBSA) plans to implement a host of new rules designed to strengthen retirement security by expanding the private employee benefit plan disclosure requirements and enhancing the availability of information to pension plan participants and beneficiaries and employers, according to the Department of Labor (DOL) **2009 Regulatory Agenda** (the "Regulatory Agenda") announced recently.

Employee Benefits, Wage & Hour, OSHA & Other Rules Seek To Protect Workers With Transparency

According to the Regulatory Agenda, EBSA plans to promote these goals through the implementation of a host of new rules including:

- Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, which would increase transparency between individual account pension plans and their participants and beneficiaries by ensuring that participants and beneficiaries are provided the information they need, including information about fees and expenses, to make informed investment decisions.
- Amendment of Standards Applicable to General Statutory Exemption for Services, which would require service providers to disclose to plan fiduciaries services, fees, compensation and conflicts of interest information.
- Annual Funding Notice for Defined Benefit Plans, which would require defined benefit plan administrators to provide all participants, beneficiaries and other parties with detailed information regarding their plan's funding status.
- Periodic Pension Benefits Statements, which would require pension plans to provide participants and certain beneficiaries with periodic benefit statements.
- Multiemployer Plan Information Made Available on Request, which would require pension plan administrators to provide copies of financial and actuarial reports to participants and beneficiaries, unions and contributing employers on request.

The 2009 Regulatory Agenda highlights the most noteworthy and significant regulatory projects that the Labor Department has established for the EBSA, the

Employment Standards Administration (ESA), Mine Safety and Health Administration (MSHA), Occupational Safety and Health Administration (OSHA), and Employment and Training Administration (ETA) for the upcoming year. In addition to the transparency rules planned for EBSA, the 2009 Regulatory Agenda also indicates that employers can expect new Labor Department regulations targeting transparency in other areas. These include:

- The MSHA to propose a rule on Notification of Legal Identity, which would require mine operators to provide increased identification information, would allow the agency to better target the most egregious and persistent violators and deter future violations.
- The Office of Labor-Management Standards' to propose regulations on Notification of Employee Rights Under Federal Labor Laws, which would implement Executive Order 13496 and require all Government contracting agencies to include a contract clause requiring contractors to inform workers of their rights under Federal labor laws.
- The Wage and Hour Division to update its regulations about Records to be Kept by Employers Under the Fair Labor Standards Act to enhance the transparency and disclosure to workers as to how their wages are computed and to allow for new workplace practices such as telework and flexiplace arrangements.
- OSHA to modify its Hazard Communication Standard to require standardized labeling requirements and order of information for safety data sheets and to update its Occupational Injury and Illness Recording and Reporting Requirements rule, which would propose the collection of additional data to help employers and workers track injuries at individual workplaces, improve the Nation's occupational injury and illness information data, and assist the agency in its enforcement of the safety and health workplace requirements.

Other Employee Benefit Regulations Planned

Beyond its planned EBSA transparency initiative, the 2009 Regulatory Agenda reflects that other EBSA regulatory priorities for the year ahead include:

- Issue guidance implementing the group health plan Genetic Information Nondiscrimination Act of 2008 (GINA) amendments to ERISA which generally prohibit group health plans from discriminating in health coverage based on genetic information and from collecting genetic information. This will be a joint rulemaking action with the Departments of Health and Human Services and the Treasury.
- Provide guidance regarding the Paul Wellstone and Pete Domenici Mental Health Parity and Addiction Equity Act of 2008 (MHPAEA) amendments to ERISA. MHPAEA creates parity for mental health and substance use disorder benefits under group health plans by mandating that any financial requirements and treatment limitations applicable to mental health and substance abuse disorder benefits to be no more restrictive than predominant

requirements or limitations applied to substantially all medical and surgical benefits covered by a plan.

- Issue guidance clarifying the circumstances under which health care arrangements established or maintained by state or local governments for the benefit of non-governmental employees do not constitute an employee welfare benefit plan for purposes of ERISA.
- Propose amendments to its regulations to clarify the circumstances under which a person will be considered a fiduciary when providing investment advice to employee benefit plans and their participants and beneficiaries of such plans.
- Explore steps it can take by regulation, or otherwise, to encourage the offering of lifetime annuities or similar lifetime benefits distribution options for participants and beneficiaries of defined contribution plans.

Mishandling Employee Benefit Obligations Creates Liabilities For Distressed Businesses & Their Business Leaders

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Business owners, executives, board members, and other business leaders of companies facing financial challenges should heed a mounting series of recent fiduciary liability settlement orders, judgments and prosecutions as strong reminders of the potential personal risk they may face if their health, 401(k) or other employee benefit programs are not appropriately funded and administered as required by the Employee Retirement Income Security Act of 1974, as amended (ERISA).

Businesses leaders struggling to deal with economic setbacks frequently may be tempted to use employee benefit plan contributions or funds for added liquidity or otherwise fail to take appropriate steps to protect and timely deposit plan contributions or other plan assets. A long and ever-mounting series of decisions demonstrates the risks of yielding to these temptations for businesses that sponsor these plans and the business leaders that make these decisions.

The mishandling of employee benefit obligations by financially distressed companies during the ongoing economic downturn is fueling an increase in Department of Labor Employee Benefit Security Administration (EBSA) enforcement actions against distressed or bankrupt companies and their officers or directors for alleged breaches of fiduciary duties or other mishandling of medical, 401(k) or other pension, and other employee benefit programs sponsored by their financially distressed companies.

EBSA enforcement activities during 2009 continue to highlight the longstanding and ongoing policy of aggressive investigation and enforcement of alleged misconduct by companies, company officials, and service providers in connection with the maintenance, administration and funding of ERISA-regulated employee benefit plans. A review of the Labor Department's enforcement record makes clear that where the Labor Department perceives that a plan sponsor or its management fails to take appropriate steps to protect plan participants, the Labor Department will aggressively pursue enforcement regardless of the size of the plan sponsor or its plan, or the business hardships that the plan sponsor may be facing.

EBSA reports enforcing $1.3 billion in recoveries related to pension, 401(k), health and other benefits during fiscal year 2009. EBSA has filed numerous lawsuits to compel distressed companies and/or members of their management to pay restitution or other damages for alleged breaches of ERISA fiduciary duties, to appoint independent fiduciaries, or both for plans sponsored by bankrupt or financially distressed companies.

Recent settlements and judgments obtained by the Labor Department and through private litigation document that officers and other members of management participating, or possessing authority to influence, the handling of heath, 401(k) and other pension, or other employee benefit plans regulated by ERISA may be exposed to personal liability if these benefit programs are not maintained and administered appropriately. This risk is particularly grave when the sponsoring company becomes financially distressed or goes bankrupt, as the handling of employee benefit and other responsibilities becomes particularly disrupted and the lack of company liquidity often leaves executives and service providers as the only or best source of recovery for government officials and private plaintiffs.

In the December 2, 2009 decision in *Solis v. Struthers Industries Inc.,* for instance, a federal district judge ordered business leader Jomey B. Ethridge liable to pay $303,084.61 to restore assets belonging to the 401(k) plan of bankrupt Struthers Industries in an ERISA fiduciary responsibility action filed by the U.S. Department of Labor’s Employee Benefits Security Administration (EBSA). Filed by the EBSA in the U.S. District Court for the Southern District of Mississippi, the *Struthers Industries* lawsuit alleged that Ethridge and Struthers Industries allowed employee contributions to be used for purposes other than providing benefits resulting in losses of $310,084.57. According to court documents, Struthers Industries designed and built heat transfer and pressure vessels at its Gulfport facility. In 2001, its 401(k) plan had 278 participants and assets totaling $8,279,083. The company filed for bankruptcy in 2003, and its assets were auctioned off in 2005. An independent fiduciary was appointed by the court in 2007 to manage the plan’s assets. The ordered Ethridge personally to pay $303,084.61 in restitution to the plan for his involvement in the mishandling of the plan’s assets. The order also bars Ethridge from acting as a benefit plan fiduciary in the future.

The *Struthers Industries* decision comes on the heels of EBSA’s success in *Solis v. T.E. Corcoran Co. Inc*. last month in recovering more than $89,000 from business owners and operators found to have breached fiduciary duties to the participants of the T.E. Corcoran Co. Inc. Profit Sharing Plan by improperly loaning plan assets to he plan sponsor and an affiliated company. The Labor Department sued T.E. Corcoran Co. and its owners, John F. Corcoran and Thomas E. Corcoran Jr., alleging that the company and its owners caused the plan to lend money to the two companies at below market interest rates, without terms of payment and without documentation in violation of ERISA. The suit filed in the U.S. District Court for the District of Massachusetts, also named as a defendant Coran Development Co. Inc., a company co-owned by the Corcorans. T.E. Corcoran Co. Inc. was the sponsor and administrator of the plan, while John and Thomas Corcoran were trustees of the plan, making all three fiduciaries and parties in interest with respect to the plan. ERISA specifically prohibits the use of employee benefit plan funds to benefit parties in interest.

The *Corcoran* judgment requires that the plan account balances of defendants John F. Corcoran and Thomas E. Corcoran Jr. be offset in the amount of $89,273 plus interest to be allocated to the accounts of the other plan participants. The offset will make whole all of the accounts of the non-trustee participants. In addition, the court order appoints an independent trustee to oversee the final distribution of the plan's assets and the proper termination of the plan, requires the defendants to cooperate fully with the independent trustee in this process, and then prohibits them from serving as fiduciaries to any ERISA-covered plan for 10 years.

A complex maze of ERISA, tax and other rules make the establishment, administration and termination of employee benefit plans a complicated matter. When the company sponsoring a plan goes bankrupt or becomes distressed, the rules, as well as the circumstances can make the administration of these responsibilities a powder keg of liability for all involved. Companies and other individuals that in name or in function possess or exercise discretionary responsibility or authority over the maintenance, administration or funding of employee benefit plans regulated by ERISA frequently are found to be accountable for complying with the high standards required by ERISA for carrying out these duties based on their functional ability to exercise discretion over these matters, whether or not they have been named as fiduciaries formally.

Despite these well-document fiduciary exposures and a well-established pattern of enforcement by the Labor Department and private plaintiffs, many companies and their business leaders fail to appreciate the responsibilities and liabilities associated with the establishment and administration of employee benefit plans. Frequently, companies sponsoring their employee benefit plans and their executives mistakenly assume that they can rely upon vendors and advisors to ensure that their programs are appropriately established. The establishment and maintenance of these arrangements with limited review or oversight by the sponsoring company or its management team can be risky.

In other instances, businesses and their leaders do not realize that the functional definition that ERISA uses to determine fiduciary status means that individuals participating in discretionary decisions relating to the employee benefit plan, as well as the plan sponsor, may bear liability under many commonly occurring situations if appropriate care is not exercised to protect participants or beneficiaries in these plans.

For this reason, businesses providing employee benefits to employees or dependents, as well as members of management participating in, or having responsibility to oversee or influence decisions concerning the establishment, maintenance, funding, and administration of their organization's employee benefit programs need a clear understanding of their responsibilities with respect to such programs, the steps that they should take to demonstrate their fulfillment of these responsibilities, and their other options for preventing or mitigating their otherwise applicable fiduciary risks.

Employee Benefit Plan Sponsors & Fiduciaries Urged To Review Bonding, Credentials of Staff & Service Providers Under ERISA

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Businesses sponsoring employee benefit plans and officers, directors, employees and others acting as fiduciaries with respect to these employee benefit plans should take steps to confirm that all of the appropriate fiduciary bonds required by the Employee Retirement Income Security Act of 1974, as amended (ERISA) are in place, that all employee benefit plans sponsored are appropriately covered, and that all individuals serving in key positions requiring bonding are covered and appropriately qualified to serve in that capacity under ERISA and the terms of the bond. Adequate attention to these concerns not only is a required component of ERISA's fiduciary compliance, it also may provide invaluable protection if a dishonesty or other fiduciary breach results in a loss or other exposure.

ERISA generally requires that every employee benefit plan fiduciary, as well as every other person who handles funds or other property of a plan (a "plan official"), be bonded if they have some discretionary control over a plan or the assets of a related trust. While some narrow exceptions are available to this bonding requirement, these exceptions are very narrow and apply only if certain narrow criteria are met.

Plan sponsors and other plan fiduciaries should take steps to ensure that all of the bonding requirements applicable to their employee benefit plans are met at least annually. Monitoring these compliance obligations is important not only for the 401(k) and other retirement plans typically associated with these requirements, but also for self-insured medical and other ERISA-covered employee benefit plans.

This process of credentialing persons involved with the plan and auditing bonding generally should begin with adopting a written policy requiring bonding and verification of credentials and that that appropriate bonds are in place for all internal personnel and outside service providers.

Steps should be taken to ensure that the required fiduciary bonds are secured in sufficient amounts and scope to meet ERISA's requirements. In addition to confirming the existence and amount of the fiduciary bonds, plan sponsors and fiduciaries should confirm that each employee plan for which bonding is required is listed in the bond and that the bond covers all individuals or organizations that ERISA requires to be bonded. For this purpose, the review should verify the sufficiency and adequacy of bonding in effect for both internal personnel as well as outside service providers. In the case of internal personnel, the adequacy of the bonds should be reviewed annually to ensure that bond amounts are appropriate. Unless a service provider provides a legal opinion that adequately demonstrates that an ERISA bonding exemption applies, plan sponsors and fiduciaries also should require that third party service providers provide proof of appropriate bonding as well as to contract to be bonded in accordance with ERISA and other applicable laws, to provide proof of their bonded status or documentation of their exemption, and to provide notice of events that could impact on their bonded status.

When verifying the bonding requirements, it also is a good idea to conduct a criminal background check and other prudent investigation to reconfirm the credentials and suitability of individuals and organizations serving in fiduciary positions or otherwise acting in a capacity covered by ERISA's bonding requirements. ERISA generally prohibits individuals convicted of certain crimes from serving, and prohibits plan sponsors, fiduciaries or others from knowingly hiring, retaining, employing or otherwise allowing these convicted individuals during or for the 13-year period after the later of the conviction or the end of imprisonment, to serve as:

- An administrator, fiduciary, officer, trustee, custodian, counsel, agent, employee, or representative in any capacity of any employee benefit plan,
- A consultant or adviser to an employee benefit plan, including but not limited to any entity whose activities are in whole or substantial part devoted to providing goods or services to any employee benefit plan, or
- In any capacity that involves decision-making authority or custody or control of the moneys, funds, assets, or property of any employee benefit plan.

Knowing or intentional violation of this prohibition may expose violating party to fines of up to $10,000, imprisonment for not more than five years, or both. Even where the violation is not knowing or willful, however, allowing disqualified persons to serve in fiduciary roles can have serious consequences such as exposure to Department of Labor penalties and personal liability for breach of fiduciary duty for damages resulting to the plan if it is established that the retention of services was an imprudent engagement of such an individual that caused the loss. When conducting such a background check, care should be taken to comply with the applicable notice and consent requirements for conducting third party conducted background checks under the Fair Credit Reporting Act (FCRA) and otherwise applicable law. As such background investigations generally would be conducted in such a manner as to qualify as a credit check for purposes of the FCRA, conducting background checks in a manner that violates the FCRA credit check requirements itself can be a source of significant liability.