RECENT OHIO FORECLOSURE CASES: LENDERS BEWARE

By Stephen R. Buchenroth and Gretchen D. Jeffries

Two recent foreclosure cases from the United Stated District Court for the Northern District of Ohio have created a stir among real estate lawyers and the securitization industry. In both instances, the court dismissed complaints to foreclose on mortgages because the plaintiff-lender failed to submit to the court a copy of the assignment of the note and mortgage evidencing the plaintiff's status as holder of the note and mortgagee under the mortgage.

The decisions surprised some lawyers who have apparently grown accustomed to the lax practice of a number of courts of allowing attorneys for foreclosing mortgagees to obtain a judgment decree of foreclosure without requiring proof of their standing in the form of an endorsed note and recorded assignment of the mortgage. While it may create some logistical problems for foreclosing lenders who have taken assignment without requiring all the formal procedures to be satisfied, the decisions should come as no surprise to anyone familiar with foreclosure law in the State of Ohio. In fact, the courts' decisions are merely a restatement of Ohio Foreclosure Law 101 – to obtain judgment on a promissory note, the plaintiff must be able to provide evidence that it is the holder of the note, and to obtain a decree in foreclosure the plaintiff must prove that it is the mortgagee of record. There are no shortcuts to those requirements.

***In re Foreclosure Cases*, 2007 WL 3232430 (N.D.Ohio, Oct. 31, 2007)**

In a somewhat colorful opinion, Judge Christopher A. Boyko dismissed fourteen foreclosure actions based on plaintiff-lender's inability to establish standing for the actions at the time of filing of the complaint. Judge Boyko stated that the notes/mortgages attached to the complaint identified the mortgagee and promisee as the original lending institution, not the plaintiff-lender, and no reference to the plaintiff-lender could be located in the chain of title. Further, Judge Boyko noted that later-proffered assignments of the notes/mortgages did not show the plaintiff-lender to be the owner of the notes/mortgages as of the date of the complaint; rather the assignments expressed a present intent to convey all rights in the notes/mortgages to the plaintiff-lender upon receipt of sufficient consideration on the date such assignments were signed and notarized.

Judge Boyko dismissed plaintiff-lender's argument that it is the "real party in interest" (Fed.R.Civ.P. 17), as not apropos to the foreclosure complaints. Judge Boyko cited the commentary to Fed.R.Civ.P. 17 which states, "[t]he provision should not be misunderstood or distorted. It is intended to prevent forfeiture when determination of the proper party to sue is difficult or when an understandable mistake has been made.... It is, in cases of this sort, intended to insure against forfeiture and injustice…." Judge Boyko found that the plaintiff-lender neither alleged mistake nor that a party could not be identified and that the plaintiff-lender would not suffer injustice by the dismissal of the complaints other than on the merits.

Judge Boyko went on to admonish that “[t]his Court acknowledges the right of banks, holding valid mortgages, to receive timely payments. And, if they do not receive timely payments, banks have the right to properly file actions on the defaulted notes-seeking foreclosure on the property securing the notes. Yet, this Court possesses the independent obligations to preserve the judicial integrity of the federal court and to jealously guard federal jurisdiction. Neither the fluidity of the secondary mortgage market, nor monetary or economic considerations of the parties, nor the convenience of the litigants supersede those obligations.”

In one of the more colorful footnotes to a decision, Judge Boyko expressed his disdain for plaintiff-lenders skirting the formal requirements for establishing jurisdiction and standing: “[u]nlike the focus of financial institutions, the federal courts must act as gatekeepers, assuring that only those who meet diversity and standing requirements are allowed to pass through. Counsel for the institutions are not without legal argument to support their position, but their arguments fall woefully short of justifying their premature filings, and utterly fail to satisfy their standing and jurisdictional burdens. The institutions seem to adopt the attitude that since they have been doing this for so long, unchallenged, this practice equates with legal compliance. Finally put to the test, their weak legal arguments compel the Court to stop them at the gate. The Court will illustrate in simple terms its decision:

> ‘Fluidity of the market’-‘X’ dollars,
> ‘contractual arrangements between institutions and counsel’-‘X’ dollars,
> ‘purchasing mortgages in bulk and securitizing’-‘X’ dollars,
> ‘rush to file, slow to record after judgment’-‘X’ dollars,
> ‘the jurisdictional integrity of United States District Court’-‘Priceless.’”

A recent decision from the United Stated District Court for the Southern District of Ohio paid homage to Judge Boyko’s flair for certain pop culture references, as well as his holding in this case by finding “with regard [to] the enforcement of standing and other jurisdictional requirements pertaining to foreclosure actions, this Court is in full agreement with Judge Christopher A. Boyko of the United States District Court for the Northern District of Ohio who recently stressed that the judicial integrity of the United Stated District Court is ‘Priceless’”. *In re Foreclosure Cases*, 2007 WL 4056586 (S.D. Ohio, Nov. 15, 2007).

***In re Foreclosure Actions*, 2007 WL 4034554 (N.D.Ohio, Nov. 14, 2007)**

Two weeks after Judge Boyko’s decision, Judge Kathleen McDonald O’Malley followed Judge Boyko’s lead by dismissing thirty-two foreclosure actions for lack of standing. In a less colorful, but tightly reasoned case, Judge O’Malley acknowledged that “a foreclosure plaintiff…especially one who is not identified on the note and/or mortgage at issue, must attach to its complaint documentation demonstrating that it is the owner and holder of the note and mortgage upon which suit was filed. In other words, a foreclosure plaintiff must provide documentation that it is the owner and holder of the note and mortgage as of the date the foreclosure action is filed." Judge O'Malley further set forth that an affidavit alone, in which the affiant simply attests that the plaintiff is the owner and holder of the note and mortgage, is insufficient and that the appropriate documentation includes assignment documents executed before the foreclosue action was commenced.

These Ohio decisions have further stoked an already hot debate among real estate lawyers regarding the status of MERS (Mortgage Electronic Registration Systems) and its ability to foreclose on mortgages. In its ordinary course of business, MERS transfers ownership of mortgages electronically between MERS members without paper assignments and without any indication to county clerks' or county recorders' offices where the subject properties are located. Recent case law around the nation and even within states is varied on whether MERS has standing to foreclose on a mortgage.

On the one hand, pundits argue that MERS has standing to foreclose on a mortgage because MERS is the legal holder of the note (and the mortgage which transfers as an incident of the note), despite the fact MERS has no beneficial ownership.

A recent decision in New York held that MERS had standing to foreclose on a mortgage when the record showed that the note was endorsed by the originating bank to a subsequent bank and ultimately transferred and tendered to MERS. *Mortgage Electronic Registration Systems, Inc. v. Coakley*, 41 A.D.3d 674 (N.Y.A.D. 2d Dept., 2007). The Court concluded that at the time of the commencement of the action, MERS was the lawful holder of the promissory note and of the mortgage, and accordingly, had standing to bring the action. The Court also found support for its position in the terms of the mortgage instrument in which the defendant had expressly agreed without qualification that MERS had the right to foreclose upon the premises in the event of default.

A recent Florida case also found that a nominee in possession of a note has standing to foreclose on the mortgage, even though the nominee is not the beneficial owner of the note and mortgage. *Mortgage Electronic Registration Systems, Inc. v. Azize*, 965 So.2d 151 (Fla. App. 2d, 2007). While the Court remanded the case to determine whether MERS had possession of the note, the Court found that MERS is a collection agent for the purposes of enforcing mortgage notes and MERS would have standing to file foreclosures if MERS could show itself to be the owner or holder of the note.

On the other hand, some courts are reticent to establish that MERS has standing to pursue a foreclosure action, because MERS does not hold the beneficial interest in the note/mortgage. Such deference for the beneficial owner of the note/mortgage is evidenced in a 2006 case out of New York. *LaSalle Bank National Association v. Lamy*, 12 Misc.3d 1191(A) (N.Y.Supp. 2006). The court held that LaSalle Bank, as assignee of MERS, had no ownership in the mortgage and as such, no cognizable claim for foreclosure. The Court stated that "it is axiomatic that to be effective, an assignment of a note and mortgage given as security therefor must be made by the owner of such note and mortgage and that an assignments made by entities having no ownership interest in the note and mortgage pass no title therein to the assignee." The court then stated that a nominee of the owner of a note and mortgage may not effectively assign the note and mortgage to another for want of an ownership interest in said note and mortgage by the nominee.

Although the ability of MERS to pursue foreclosure actions will continue to be fleshed out in the courts, the Ohio decisions serve as a warning to all lenders and their counsel that the courts will no longer be asleep behind the wheel while the formal procedural requirements regarding assignment of notes and mortgages are ignored.

****

Stephen R. Buchenroth is a partner in the Columbus office of Vorys, Sater, Seymour and Pease LLP and a former head of the firm's real estate and commercial practice group. He is a former Chairman of the Real Property Section of the Ohio State Bar Association and a member of the American College of Real Estate Lawyers. Gretchen Jeffries is an associate in the Columbus office of Vorys, Sater, Seymour and Pease LLP and a member of its commercial and real estate group. Ms. Jeffries is a graduate of The Ohio State University and The University of Texas School of Law.

The Legal Reality of Virtual Real Property

By Nancy Grekin

Virtual real property took on actual life in the case of *Bragg v. Linden Research, Inc.*, No. CIV.AO6 4925 (E.D.P.A., May 30, 2007). The plaintiff, a lawyer, sued Linden Research, Inc. (the “Company”) the creator of a virtual reality Web site called “Second Life”, alleging that it had improperly confiscated his virtual property and denied him access to its virtual community. He also joined the President and CEO of the Company for having made personal representations which led him to participate in Second Life. The case covered a variety of procedural issues which resulted in the determination that a Federal District Court in the State of the plaintiff’s residence had personal jurisdiction over the CEO, and that its on-line terms of service (“TOS”) contract was unconscionable. Because the contract between the user and the Web site was unconscionable, the arbitration clause which users were required to accept in order to participate would not be enforced. The case provides lessons on how to prepare a TOS for acceptance on the Internet, and a warning that the operator of a Web site and its principals may be sued virtually anywhere.

Plaintiff signed up and paid defendant to participate in the Second Life virtual world. Participants use the site by creating “avatars”, which are virtual depictions of themselves, and which interact with other participants in the Second Life virtual communities. Second Life agreed to recognize the intellectual property rights of the digital content created by participants, permitting them to buy, own and sell virtual goods and property, including land. The owners of virtual land could exclude others, improve it, and rent it and sell it to other avatars for a profit. Plaintiff purchased numerous parcels of virtual land, paid defendant real money as property tax, and created a digital business of selling fireworks for a profit to other avatars. He also acquired other virtual items from other avatars. In order to participate, the plaintiff was required to agree to defendant’s on-line TOS. The TOS required, among other provisions, that any dispute between the company and the user be decided by arbitration in California where the Company is located.

The dispute arose because the plaintiff acquired a parcel of virtual land for $300 but the defendant informed him that he had improperly purchased the land through an “exploit.” The defendant then froze the plaintiff’s account, and confiscated all of the virtual property and currency that he maintained at Second Life. The Plaintiff sued the Company and its President and CEO, Philip Rosedale. Rosedale moved to dismiss for lack of personal jurisdiction, and the Company moved to compel arbitration.

Motion (of Rosedale) to Dismiss for Lack of Personal Jurisdiction

Personal jurisdiction can be established either by “specific jurisdiction” when the basis of the plaintiff’s claim is related to or arises out of the defendant’s contacts with the forum, or by “general jurisdiction” which need not relate to the defendant’s contacts with the forum in connection with the underlying cause of action, but will be established if the contacts were “continuous and systematic.” The plaintiff maintained that Rosedale’s representations made in national media supported personal jurisdiction.

To establish personal jurisdiction it must be shown that the defendant had sufficient contacts with the forum to have anticipated that he could be sued there. The plaintiff alleged that Rosedale personally made statements in the media to a national audience regarding Second Life, and that those representations induced the plaintiff to participate. Further Rosedale hosted “town meetings” at Second Life at which he made various statements about the purchase of virtual land. The Court held that these personal representations made to induce participation in Second Life and the purchase of virtual land, were sufficient contacts to support personal jurisdiction.

Further, the Court ruled that the exercise of personal jurisdiction would not offend due process because there was no undue burden on Rosedale to defend in Pennsylvania, and because Pennsylvania has a substantial interest in protecting its citizens from misleading representations that would induce them to purchase virtual property.

Rosedale argued that because he made the representations in his capacity as chief executive officer of Linden Research, Inc. that he could not be subject to personal jurisdiction in his individual capacity, the so-called “fiduciary shield” doctrine. Although the Court was uncertain as to the law of Pennsylvania and the Third Circuit on this doctrine, it held that it did not apply because if a defendant had (1) a major role in the corporate structure, (2) the quality of his contacts with the State were significant, and (3) his participation in tortious contact was extensive, the doctrine would not apply. Because of his title as President and CEO and his participation in Company management, and because his statements were made on national media and he personally participated in the dissemination of the representations, he met the tests for determining that the doctrine did not apply and therefore did not preclude personal jurisdiction.

Motion to Compel Arbitration

Participants in Second Life are required to accept the on-line TOS by clicking an acceptance box. The Second Life TOS included a California choice of laws provision and an arbitration provision requiring disposition of disputes in San Francisco. The plaintiff alleged that the arbitration provision was procedurally and substantively unconscionable.

Procedural Unconscionability

The Court held that the TOS was a contract of adhesion because the other party had no opportunity for meaningful negotiation, and it was therefore procedurally unconscionable. Further the Court held that the Company clearly had superior bargaining strength which also established unconscionability. Apparently Second Life was the first virtual community on the Internet to offer its participants the right to purchase virtual land, so the Court held that there were no other reasonable market alternatives, further supporting that the TOS was a contract of adhesion. Finally, the Court noted that there was an element of “surprise” in the arbitration provision, another element of procedural unconscionability, because the provision was particularly inconspicuous and was buried in a paragraph with the heading “GENERAL PROVISIONS.”

Substantive Unconscionability

Even if a contract is procedurally unconscionable it will be enforced if the substantive terms are reasonable. A substantively unconscionable contract is one which is “one-sided.”

The Court held that the TOS was substantively unconscionable because it was entirely one-sided. It permitted the Company to suspend or terminate a user's account and to refuse use of Second Life without notice, the Company had the sole discretion to determine if the participant had breached, and it had the right to retain any equity the participant had acquired based on a mere "suspicion" of fraud. In addition, the Company could amend the agreement at any time in its sole discretion by posting the amendment to its Web site. Thus the Company had a variety of remedies for breach, while the users had only one: they were required to arbitrate.

The Court analyzed various other provisions of the TOS and concluded that the lack of mutuality, the forum selection clause, and a confidentiality provision unilaterally imposed by the Company demonstrated that the arbitration clause was not designed to provide users with an effective means of resolving disputes. Therefore it was substantively unconscionable. Because the TOS was held to be substantively unconscionable, the Court held that the arbitration clause would not be enforced.

Lessons of the Case

All Web sites are made available nationally (and internationally) so a provider such as the Company can probably be sued virtually anywhere in the county. A CEO or other corporate representative who personally participates in hyping the company's products nationally is at risk of personal liability for false or misleading statements.

The on-line TOS that Web sites require users to accept may not always be contracts of adhesion, but they certainly offer no opportunity to negotiate, are always one-sided, and are presented to users as "take it or leave it" – if a user doesn't accept it, the user cannot participate. Many TOS contracts may be substantively, if not procedurally, unconscionable based upon the theories of this case. A company seeking to enforce a provision such as an arbitration clause included in a TOS should be very careful to make the provision obvious, and not to include other onerous one-sided provisions.

In the new world of virtual reality a company which advertises nationally and which promotes its business on the Internet must be prepared to operate in the real world of the law of contracts or risk serious legal sanctions!

BEHIND ALL THE SMOKE: ARE LAWS RESTRICTING THE RIGHT TO SMOKE IN CONDOMINIUMS, TOWNHOMES AND APARTMENTS REALLY NECESSARY?

By Nancy Le

Smoking bans are heating up across the nation. A reaction to concerns over second-hand smoke, the issue has become a topic in national news stories.[1] Once limited to only public spaces, state and local municipalities are now seeking to ban smoking in private condominiums and multi-residential townhomes and apartment complexes. Developers, building owners and owners' associations are attempting to ban smoking by use of covenants. A review of state condominium/common interest development and landlord-tenants laws show that these current regulations have long been used by nonsmoking residents to protect their right to live in a smoke-free environment. Therefore, is an additional layer of governmental control over smoking in private dwellings really necessary?

Three cities in California have pioneered the way for stretching smoking bans from the park down the street into people's homes. In May of this year, the Southern California city of Temecula passed ordinances banning smoking in public areas and required apartment buildings to make at least 25 percent of their units smoke-free. In October of this year, the Northern California city of Belmont approved a law which prohibits smoking in condominiums, townhomes, and apartments. Further down the California coast, in the city of Calabasas, where smoking in public places has been illegal for over a year, the city is also considering the approval of an ordinance that would restrict smoking in multi-unit residential complexes.

<u>Common Interest Developments</u>

A common interest development ("CID") is a descriptive term used to describe multi-unit residential housing where the owners share common areas and facilities within the development. CID's generally include, among many other forms of multi-unit housing, condominiums, town homes, and multi-story residential high-rises. Most typical state CID laws provide that each development be self-governed through an association of the homeowners living within the CID.[2]

A homeowner's association of a CID is run similarly to a corporation. Bylaws are created and governing documents called the declaration of the covenants, conditions and restrictions ("CC&Rs") are adopted, which outline the rules for the operation of the association. Membership within a homeowner's association occurs automatically when an individual purchases a home within the common interest development. In addition to the CC&Rs, it is not uncommon for most homeowner associations to adopt and enforce a set of association rules that outline among other things what activities are and are not

[1] "A New Arena in the Fight Over Smoking: The Home", <u>The New York Times</u> (Nov. 5, 2007).

[2] See e.g. California Civil Code Section 1352 ("a common interest development is created whenever a separate interest coupled with an interest in the common area or membership in the association is, or has been, conveyed").

permitted within the development. For example, association rules may dictate whether or not a unit owner can have a pet, post signs in windows, lease a unit, and even more, emit noxious odors. A ban on the emission of secondhand smoke is an additional restriction that may simply be incorporated into the association rules. Without additional governmental laws, the decision to allow smoking within any CID is left to the homeowner's association

Additionally it is not uncommon for CC&Rs to include a clause prohibiting activities which may amount to a "nuisance" to other homeowners or which may interfere with other homeowners' quiet enjoyment of their properties. If the CC&Rs do not include a "nuisance" clause, a plaintiff could probably turn to the state's private nuisance statute. For example, in California, a private nuisance is defined as one that is "injurious to health…offensive to the senses, or an obstruction to the free use of property, so as to interfere with the comfortable enjoyment of life or property.…"[3] In the state of Utah, secondhand smoke is a expressly classified as a nuisance if "any tobacco smoke…drifts into any residential unit a person rents, leases…more than once in each of two or more consecutive day periods."[4] The Utah nuisance statute further provides residents of condominiums and apartments with injunctive relief or damage if exposed to nuisance tobacco smoke.[5]

If the homeowner association rules or CC&Rs are silent on the issue of smoking, an aggrieved nonsmoking member of the association may still have several legal remedies against the smoking member who is causing him or her harm. In California, the association or an owner living within a CID may sue to enforce the terms of the CC&Rs (assuming they contain a "nuisance" clause). However, California law requires that the parties first attempt to resolve the dispute by an alternative dispute resolution process prior to filing a lawsuit.[6] If the dispute resolution process is not successful, common claims brought by an aggrieved nonsmoking association member include: breach of the CC&Rs, private nuisance, intentional infliction of emotional distress, trespass, and battery.

Aside from the state of Utah, most states perform a case by case analysis of nuisance claims brought as a result of involuntary exposure to secondhand smoke in private dwellings. A review of case law on these particular types of nuisance claims shows a trend requiring plaintiffs to demonstrate a high level of exposure and injury from the secondhand smoke in order to prevail. Claims of discomfort or "annoyance" caused by involuntary exposure to secondhand smoke do not seem to be sufficient to convince a court to award damages or enjoin the conduct of the smoker.

---

[3] California Civil Code Section 3479.
[4] Utah Code Unnanotated §78-38-1(3).

[5] Id.

[6] California Civil Code Section 1369.520.

For example, in the case of Lipsman v McPherson,[7] the plaintiff, a nonsmoking tenant, sued the defendant for negligence and nuisance due to plaintiff's exposure to defendant's secondhand smoke that regularly seeped into plaintiff's apartment. The plaintiff alleged that secondhand smoke resulting from the defendant's three to six cigarettes a day caused plaintiff discomfort and "annoyance." The court entered judgment in favor of the defendant, finding that plaintiff's "annoyance" caused by the defendant's secondhand smoke was "not substantial and would not affect an ordinary person" and that "an injury to one who has specially sensitive characteristics does not constitute a nuisance."

However, in the Florida case of Merrill v. Bosser, [8] the plaintiff, a nonsmoking condominium owner, sued the defendant who lived one unit above the plaintiff. The defendant smoked about one pack of cigarettes a day, and also had a tenant who smoked. Despite the fact that the plaintiff's problems with the defendant's secondhand smoke stopped after the defendant's tenant was asked to move out, the plaintiff still brought a cause of action against the defendant for trespass, common law nuisance, and breach of the covenant of quiet enjoyment. The parties' condominium agreement had contained a covenant of quiet enjoyment. The plaintiff was awarded $1000 in damages for medical expenses, loss of use, and remedial expenses, and additional $275 for costs. In awarding the plaintiff damages, the court reasoned that the "unique facts" evidenced that the plaintiff was exposed to "excessive secondhand smoke" which amounted to a "disturbance of possession."

Apartments

In any state, a landlord or owner of multi-residential leasehold property has the authority to determine whether or not he or she wants to permit smoking on the leasehold premises. Landlords in general may prohibit any activity on the leasehold premises as long as the prohibition does not violate state or federal law. A restriction on smoking would be no different than a restriction on the number of pets, overnight guests, or parking spaces a tenant is entitled to have. These types of restrictions are generally outlined in the lease agreement between the landlord and tenant.

In the event a landlord does not want to expressly restrict smoking in the lease agreement, there are common law objections that non-smoking tenants may assert to protect their right to live in a healthy and smoke-free environment. In addition to the remedies already mentioned in this article, non-smoking tenants living within multi-unit residential leasehold properties have the common law protections pursuant to the implied covenants of habitability and quiet enjoyment.

Each state generally recognizes the implied covenant of habitability and quiet enjoyment that applies to every residential lease agreement. In California, the covenant of quiet enjoyment typically provides each tenant with the right to quiet enjoyment of his or her

---

[7] No. 191918 (Superior Court of Massachusetts, Middlesex 1991) reprinted in 12 Tobacco Products Liability Reporter 2.345 (1991)
[8] County Court of the 17th Judicial Circuit, Broward County, FL 2005.

residential apartment without a direct or indirect interference by the landlord.[9] Under the implied warranty of habitability, a landlord in a state such as California covenants that the premises shall remain in a habitable state for the duration of the lease.[10]

Under both covenants, a non-smoking tenant adversely affected by secondhand smoke could attempt to seek injunctive relief, or surrender the premises before the termination of the lease under the claim of constructive eviction. In the Oregon case of Fox Point Apt. v. Kippes,[11] the plaintiff sued the landlord for breach of the covenant of habitability and quiet enjoyment when the plaintiff began to suffer respiratory problems caused by secondhand tobacco smoked that was allowed to enter her apartment. The jury unanimously found a breach of the warranty of habitability and awarded the plaintiff a 50% reduction in rent and damages for plaintiff's medical expenses.

In the Ohio case of Dworkin v. Paley, the plaintiff, a nonsmoking tenant, prematurely terminated the lease agreement because the secondhand smoke emanating through the heating and cooling systems caused the plaintiff physical discomfort and annoyance. After terminating the lease, the plaintiff sued the landlord for breach of the covenant of quiet enjoyment. In reversing the dismissal in favor of the defendant, the appellate court held that there were "general issues of material fact concerning the amount of smoke or noxious odors being transmitted into appellant's rental unit."

Conclusion

There are not many reported decisions addressing claims related to secondhand smoke within private residential dwellings. However, both the reported and unreported decisions on this issue demonstrate that private disputes concerning the detrimental effects of secondhand smoke are being resolved through alternative dispute resolution or before an impartial tribunal. Without any governmental regulation on this issue, private property owners and associations maintain the authority to decide what legal activities, although potentially harmful to others, may be permitted on the premises. This begs the question: Is additional governmental regulation on smoking in private dwellings therefore really necessary?

Nancy Le is a real estate and corporate associate with the law firm of Kirkpatrick & Lockhart Preston Gates Ellis LLP. Nancy may be contacted at nancy.le@klgates.com.

---

9 Petroleum Collections Inc. v. Swords. 48 Cal. App. 3d 841 , 848 (1975).

10 Knight et. al v. Hallstham-Mar et. al, 29 Cal.3d 46, 51 (1981).

11 No. 92-6924 (Lackamas County Oregon District Court 1991).

Multijurisdictional Real Estate Practice and Implementation of ABA Model Rules 5.5 and 8.5

James Geoffrey Durham
University of Dayton School of Law
300 College Park
Dayton, OH 45469-2772

These materials are substantially drawn from materials prepared for a March 20, 2004, program of the American College of Real Estate Lawyers entitled "Crossing Borders: The Evolving Obstacles to Following Your Client Across State Lines" by: Kathleen M. Martin, Malkerson Gilliland Martin LLP, 220 South Sixth Street, Suite 1750, Minneapolis, MN 55402; and Mark F. Mehlman, Sonnenschein Nath & Rosenthal, 233 South Wacker Drive, Suite 8000, Chicago, IL 60606.

Multijurisdictional Real Estate Practice and Implementation of ABA Model Rules 5.5 and 8.5

A. BRIEF HISTORY OF THE MULTIJURISDICTIONAL DEBATE

1. In the early 1900s, states began enacting "unauthorized practice of law" ("UPL") legislation that prohibited persons (lawyers and non-lawyers) not licensed in a state from practicing law within that state. The most widely stated purpose of the UPL laws was to ensure that a state's citizens were represented by qualified legal practitioners. A state's UPL restrictions also operate to protect the livelihood of lawyers practicing within the state. Historically, the UPL laws had little impact on an attorney's conduct; the lawyer typically represented only clients that lived or were organized in his or her state and the clients' needs were limited to application of the laws of the lawyer's home state.

2. As clients' business needs expanded nationally and internationally during the twentieth century, however, clients increasingly sought advice from their attorneys in regard to transactions that crossed the borders of the lawyers' home states. With technological advances, changes in our transportation systems and the expansion of our economy, this cross-border, or multijurisdictional, practice led lawyers to travel to other states to negotiate or close transactions, to negotiate documents governed by the laws of other states and to sometimes render advice with respect to the application of other states' laws to the client's business dealings.

3. As lawyers more frequently crossed state lines (literally and figuratively) in service to their clients, the UPL laws were invoked not only by the states to prohibit lawyers licensed in another jurisdiction (but not licensed in the host state) from practicing in the host state, but also by clients in fee disputes with their attorneys. A key question that arose from many of these UPL cases was: under what circumstances is a lawyer licensed in one state practicing "in" another state when the transaction involves parties, laws, contract rights or other property situated in or governed by the laws of more than one jurisdiction? (An excellent survey of UPL decisions appears in William T. Barker, *Extrajurisdictional Practice by Lawyers*, 56 BUS. LAW. 1501 (2001), which is available for review at http://www.abanet.org/cpr/mjp/biblio.pdf.)

4. Perhaps the most significant case giving rise to the recent study of the American Bar Association ("ABA") *Model Rules of Professional Conduct* applicable to multijurisdictional practice was the California Supreme Court's decision in *Birbrower, Montalbano, Condon & Frank, P.C. v. Superior Court*, 949 P.2d 1 (Cal. 1998). In *Birbrower,* New York licensed lawyers were sued by their client for legal malpractice and related claims; the New York firm counterclaimed for attorneys' fees for work it had performed in both California and New York. The *Birbrower* court found that the New York lawyers had practiced law (without a license) "in" California and were not permitted to collect fees for services constituting the practice of law in California, by virtue of the following facts: the New York law firm, which had represented the client on matters of New York law for a number of years, consulted with the client, in New York, in regard to a contract governed by the laws of California; the New York lawyers traveled to California (where the other party maintained its principal place of business) on more than one occasion to meet with the other party and to negotiate resolution of the dispute; and the New York attorneys commenced arbitration with a California office of the American Arbitration Association.

5. In response to the *Birbrower* decision and similar developments in other states, ABA President Martha Barnett appointed the Commission on Multijurisdictional Practice (the "Commission") in July 2000 to, *inter alia*, "study and report on the application of current ethics and bar admission rules to the multijurisdictional practice of law" and to "make policy recommendations to govern the multijurisdictional practice of law that serve the public interest." American Bar Association, *Report of the Commission on Multijurisdictional Practice* (Aug. 2002) ("*MJP Report*"), at 1, available at http://www.abanet.org/cpr/mjp/home.html.

6. After numerous hearings, much study and extended debate, the Commission issued its final recommendations in June 2002, which were adopted by the ABA House of Delegates on August 12, 2002. *See MJP Report, supra*.

7. Among the recommendations approved by the ABA House of Delegates were amendments to Model Rule 5.5 that relax previously existing constraints on cross-border practices (MR 5.5 is available at http://www.abanet.org/cpr/mrpc/rule_5_5.html, and the comments are available at http://www.abanet.org/cpr/mrpc/rule_5_5_comm.html), amendments to Model

Rule 8.5 that subject lawyers providing legal services in a state to the disciplinary authority of that state regardless of the attorney's state of licensure, and a Model Rule for Temporary Practice by Foreign Lawyers that allows foreign counsel to provide legal services on a temporary basis in the United States in certain circumstances that closely parallel the permitted cross-border practices authorized by Model Rule 5.5. Additionally, the ABA House of Delegates approved a number of other Model Rule revisions and new Model Rules intended to relax the UPL restrictions that exist in various jurisdictions, including amended Model Rule 6A and proposed Model Rule 22 (promoting reciprocal disciplinary enforcement by a state in which the attorney has practiced and the state in which the attorney is licensed), a Model Rule on "Pro Hac Vice Admission" with respect to practice before courts and tribunals of other states, a Model Rule on "Admission by Motion" under which an attorney can pursue permanent admission to another jurisdiction's bar without taking its bar examination, and promotion of the states' adoption of a Model Rule for the "Licensing of Legal Consultants" that permits a counselor outside the United States to advise American clients about the laws of the counselor's home nation. For a detailed description of the Commission's recommendations, *see MJP Report, supra.*

8. At the ABA Midyear Meeting, February 12, 2007, the House of Delegates responded to the calls to allow lawyers displaced by major disasters to temporarily move their practices to other jurisdictions and to allow lawyers from outside the major disaster area to provide *pro bono* legal services within the major disaster area. New language was added to Comment 14 of Model Rule 5.5 and the newly adopted rule was entitled "Model Court Rule on Provision of Legal Services Following Determination of Major Disaster," *see* pages 11-14, *infra.*

B. ABA MODEL RULE 5.5, AS AMENDED IN 2002, AFFIRMATIVELY PERMITS CERTAIN CROSS-BORDER PRACTICES PERFORMED ON A TEMPORARY BASIS

1. The focus of these materials is the effect of Amended Model Rule 5.5 (now titled "Unauthorized Practice of Law; Multijurisdictional Practice," available at http://www.abanet.org/cpr/mrpc/rule_5_5.html) on outside legal counsel providing legal services to clients engaged in cross-border business. The model rule is written from the perspective of the state in which the practitioner is not admitted to practice, and the model rule uniformly requires, as a condition to any

permitted multijurisdictional conduct, that the lawyer not be suspended from practice or disbarred in any other jurisdiction.

2. Amended Model Rule 5.5 clarifies that certain actions remain prohibited:

   a. "A lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction or assist another in doing so." *Model Rule 5.5(a).*

   b. "A lawyer who is not admitted to practice in this jurisdiction shall not:
      (1) . . . establish an office or other systematic and continuous presence in this jurisdiction for the practice of law; or
      (2) hold out to the public or otherwise represent that the lawyer is admitted to practice law in this jurisdiction." *Model Rule 5.5(b).*

3. Amended Model Rule 5.5(c) affirmatively authorizes certain multijurisdictional practices conducted on a <u>temporary basis</u>:

   (c) A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction may provide legal services on a temporary basis in this jurisdiction that:

   (1) are undertaken in association with a lawyer who is admitted to practice in this jurisdiction and who actively participates in the matter;
   (2) are in or reasonably related to a pending or potential proceeding before a tribunal in this or another jurisdiction, if the lawyer, or a person the lawyer is assisting, is authorized by law or order to appear in such proceeding or reasonably expects to be so authorized;
   (3) are in or reasonably related to a pending or potential arbitration, mediation, or other alternative dispute resolution proceeding in this or another jurisdiction, if the services arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice and are not services for which the forum requires pro hac vice admission; or

(4) are not within paragraphs (c)(2) or (c)(3) and arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice. *Model Rule 5.5(c).*

Comment 5 to Model Rule 5.5, however, states that these four areas of permitted, temporary practice are intended to be examples of authorized cross-border practice: "[t]he fact that conduct is not so identified does not imply that the conduct is or is not authorized."

4. Additionally, Model Rule 5.5(d)(2) permits in-house counsel, if licensed in one United States jurisdiction and not suspended or disbarred from practice in any jurisdiction, to perform legal services in the state to the "lawyer's employer or its organizational affiliates and are not services for which the forum requires pro hac vice admission."

5. Moreover, Model Rule 5.5(d)(2) states that an attorney licensed in another jurisdiction (and not disbarred or suspended from practice elsewhere) may provide services in the state that the lawyer is "authorized to provide by federal law or other law of this jurisdiction."

C. WHAT CONSTITUTES RENDERING LEGAL SERVICES ON A TEMPORARY BASIS THAT REASONABLY RELATE TO THE LAWYER'S PRACTICE IN THE JURISDICTION IN WHICH THE LAWYER IS ADMITTED TO PRACTICE?

1. The Commission's greatest departure from common law and existing UPL restrictions affecting transactional lawyers lies in Subsection (c)(4) of Model Rule 5.5, which permits a practitioner licensed in one state to provide legal services, on a temporary basis, in other states if the services "arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice." An earlier version of subsection (c)(4) proposed by the Commission in its November 2001 interim report had limited cross-border transactional practice to non-litigation work ancillary to the lawyer's representation of a client in the jurisdiction in which the lawyer was licensed to practice law. After significant testimony by transactional lawyers (represented by ACREL, the ABA Business Law Section, the ABA Real Property, Probate and Trust Law Section, and other organizations), the Commission ultimately recognized that permitted cross-border

practices should not be dependent upon the lawyer's prior representation of the client in the lawyer's state of licensure.

2. In its report, the Commission did not state, explicitly, what constitutes a reasonable relationship to the lawyer's practice in his or her state of licensure. Rather, the Commission stated, in Comment 14 to Model Rule 5.5, that a "variety of factors evidence such a relationship," citing as examples that the client may have previously engaged the lawyer in question, the client may be a resident of or have substantial contacts in the lawyer's home state, the matter at issue may have "significant connection" with the lawyer's home state or "when the client's activities or the legal issues involve multiple jurisdictions, such as when the officers of a multinational corporation survey potential business sites and seek the services of their lawyer in assessing the relative merits of each."

3. Comment 5 to Model Rule 5.5 states that "continuous presence" in a jurisdiction "may be systematic and continuous even if the lawyer is not physically present" in the state, and a lawyer not licensed in the state "must not hold out to the public or otherwise represent that the lawyer is admitted to practice law" in the host jurisdiction.

4. Comment 6 further states that there "is no single test to determine whether a lawyer's services are provided on a 'temporary basis,'" given that professional advice may be temporary "even though the lawyer provides services in this jurisdiction on a recurring basis, or for an extended period of time, as when the lawyer is representing a client in a single lengthy negotiation or litigation."

D. PRACTICE TIPS FOR THE REAL ESTATE ATTORNEY ENGAGED IN CROSS-BORDER PRACTICE

1. Practitioners must be mindful that Model Rule 5.5., as amended, only applies in those United States jurisdictions that have adopted the amended rule, although that is getting easier because the District of Columbia and most states have adopted some form of Model Rule 5.5 (*see* paragraph 2, *infra*). The Commission affirmed in its report its belief that "the principle of the regulation of the practice of law by the state judicial branch of government, which includes jurisdictional limits on the legal practice, should be preserved. . . ." *MJP Report,* at 13.

2. As of October, 2007, the ABA reported that that the revision of Model Rule 5.5 on multijurisdictional practice, and the related amendments to Model Rule 8.5 on disciplinary authority in cases involving cross-border practice, have been adopted and are effective in form identical to or substantially similar to the 2002 Model Rule Revisions in the highest courts of the District of Columbia and 34 states: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Idaho, Indiana, Iowa, Louisiana, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Utah, Washington, and Wyoming. Three states have adopted one but not the other: Montana, and Wisconsin have adopted Model Rule 8.5 but the adoption Model Rule 5.5 is still pending in Montana, while in Wisconsin it has been recommended for adoption; and Alabama has adopted Model Rule 5.5 but is still studying Model Rule 8.5. Recommendations to adopt the model rule revisions in form identical or substantially similar to the 2002 Model Rule Revisions are pending in the highest courts of six states: Illinois, Kentucky, Maine, Michigan, New York, and Virginia. MJP Study Committees in two other states have recommended adoption of rules identical or similar to the 2002 Model Rules: Alaska and Vermont. Five other jurisdictions have created study committees to consider the 2002 Model Rules revisions: Hawaii, Mississippi, Tennessee, Texas, and West Virginia. For a summary of the status of implementation of revised Model Rule 5.5 in the various United States jurisdictions as of October 16, 2007, *see* the ABA table available at http://www.abanet.org/cpr/mjp/quick-guide-5.5.pdf (adoption of Model Rule 5.5 is still listed as pending in Connecticut). For a more detailed statement of the status of the various jurisdictions' implementation of Model Rule 5.5, Model Rule 8.5 and Model Rule for Temporary Practice by Foreign Lawyers, as of October 15, 2007, *see* the ABA table available at http://www.abanet.org/cpr/mjp/impl-mjp-rules07.pdf (which includes state specific websites). For a summary description of the implementation of Model Rule 8.5, *see* the ABA table available at http://www.abanet.org/cpr/mjp/8_5_quick_guide.pdf. Each of these summary tables is regularly updated and posted to the Commission's website, http://www.abanet.org/cpr/mjp/home.html.

3. Because the separate jurisdictions' review and implementation processes for revised Model Rule 5.5, and the corresponding revisions to Model Rule 8.5, are

ongoing, the real estate practitioner, before providing advice with respect to a transaction that involves the laws of, parties related to or property in another state, should consult the current status of such other state's implementation of the Model Rule revisions. The ABA tables included in these materials are an excellent source of information.

4. Furthermore, as noted by the Commission, "restrictions on unauthorized practice of law are also embodied in laws and rules that differ from state to state," such that care must be exercised by the practitioner venturing across state borders to ensure that appropriate legislative reform has been coupled with adoption of the Model Rules. *MJP Report,* at 23. The ABA maintains a summary chart that provides some guidance in this area: http://www.abanet.org/cpr/mjp/impl-mjp-rules07.pdf.

5. Commentators on the Commission's Model Rule revisions have noted that revisions to Model Rule 8.5 (which subjects the cross-border lawyer to the disciplinary authority of both the lawyer's home state and the state in which the lawyer provides legal advice and includes choice of law provisions governing the issue of which state's disciplinary rules apply) appear to be the "price that lawyers must pay for the opportunity for limited interstate practice." ABA/BNA Lawyers' Manual on Professional Conduct, *Conference Report,* August 14, 2002. (Note that, even in-house lawyers, under revised Model Rule 8.5, would be subject to the disciplinary authority of the host state, and in-house counsel must be mindful that they may still be subject to the host state's licensing and registration requirements. *Model Rule 5.5, comment 17).* A complete compilation of amended Model Rule 8.5, and the Comments thereto, are set forth in Appendix C to the *MJP Report.*

6. As the Commission cautions, "in the context of determining whether work performed outside the lawyer's home state is reasonably related to the lawyer's practice in the home state, as is true in the many other legal contexts in which a 'reasonableness' standard is employed, some judgment must be exercised." *MJP Report,* at 29.

7. Real estate lawyers must remain mindful of a separate ethical standard, set forth in Model Rule 1.1 (and adopted in most, if not all, states), which mandates that a "lawyer shall provide competent representation to a client. Competent

representation requires the legal knowledge, skill, thoroughness and preparation necessary for the representation." As noted in Raymond J. Werner, *Licensed in One State, But Practicing in Another: Multijurisdictional Practice,* PROBATE AND PROPERTY (March/April 2003) 6, at 9:

> If the lawyer knows or is concerned that a certain legal issue may be treated differently under the law of a state that governs a transaction, the lawyer is duty bound to investigate that issue and react accordingly. Acquiring knowledge of relevant law and using it are merely aspects of the professionalism that sophisticated clients expect and to which all clients are entitled. Moreover, the lawyer has an obligation to explain matters to the client so as to enable the client to make an informed decision regarding matters that are the subject of the representation. *Model Rule 1.4(b).* If the lawyer believes that there are limits on the lawyer's ability to represent the client, the lawyer must so inform the client so the client can decide how to proceed.

The prudence of informing the client that the lawyer is not licensed in a particular jurisdiction was reinforced by the Commission in Comment 20 to amended Model Rule 5.5: "In some circumstances, a lawyer who practices law in this jurisdiction . . .may have to inform the client that the lawyer is not licensed . . .in this jurisdiction. For example, that may be required when the representation occurs primarily in the jurisdiction and requires knowledge of the laws of this jurisdiction. See Rule 1.4(b)."

8. Engaging local counsel, while recognized in Model Rule 5.5.(c)(1) as a legitimate safe harbor, still requires that local counsel "actively participate in and share responsibility for the representation of the client." *Model Rule 5.5, Comment 8.*

9. An out-of-state lawyer engaging in a representation involving litigation or arbitration is, of course, treated differently by Model Rule 5.5. While it often is relatively easy for an out-of-state lawyer engaged to represent a client in a court proceeding to be admitted *pro hac vice*, the states have had a great deal of difficulty in determining how to handle out-of-state lawyers representing clients in arbitrations. For example, Rule 1-3.11 of the Rules Regulating The Florida Bar requires out-of-state lawyers to file a statement with The Florida Bar in all

domestic arbitration proceedings, pay a $250 fee, and only engage in domestic arbitration proceedings in Florida no more than three times in a 365 day period.

AMERICAN BAR ASSOCIATION

ADOPTED BY THE HOUSE OF DELEGATES
February 12, 2007

RECOMMENDATION

RESOLVED, That the American Bar Association adopts the *Model Court Rule on Provision of Legal Services Following Determination of Major Disaster*, dated February 2007.

FURTHER RESOLVED, That the American Bar Association amends Comment [14] to Rule 5.5 of the *Model Rules of Professional Conduct*.

Model Court Rule on Provision of Legal Services Following Determination of Major Disaster
(February 2007)

Rule ___. Provision of Legal Services Following Determination of Major Disaster

(a) Determination of existence of major disaster. Solely for purposes of this Rule, this Court shall determine when an emergency affecting the justice system, as a result of a natural or other major disaster, has occurred in:

(1) this jurisdiction and whether the emergency caused by the major disaster affects the entirety or only a part of this jurisdiction, or

(2) another jurisdiction but only after such a determination and its geographical scope have been made by the highest court of that jurisdiction. The authority to engage in the temporary practice of law in this jurisdiction pursuant to paragraph (c) shall extend only to lawyers who principally practice in the area of such other jurisdiction determined to have suffered a major disaster causing an emergency affecting the justice system and the provision of legal services.

(b) Temporary practice in this jurisdiction following major disaster. Following the determination of an emergency affecting the justice system in this jurisdiction pursuant to paragraph (a) of this Rule, or a determination that persons displaced by a major disaster in another jurisdiction and residing in this jurisdiction are in need of pro bono services and the assistance of lawyers from outside of this jurisdiction is required to help provide such assistance, a lawyer authorized to practice law in another United States jurisdiction, and not disbarred, suspended from practice or otherwise restricted from practice in any jurisdiction, may provide legal services in this jurisdiction on a temporary basis. Such legal services must be provided on a pro bono basis without compensation, expectation of compensation or other direct or indirect pecuniary gain to the lawyer. Such legal services shall be assigned and supervised through an established not-for-profit bar association, pro bono program or legal services program or through such organization(s) specifically designated by this Court.

(c) Temporary practice in this jurisdiction following major disaster in another jurisdiction. Following the determination of a major disaster in another United States jurisdiction, a lawyer who is authorized to practice law and who principally practices in that affected jurisdiction, and who is not disbarred, suspended from practice or otherwise restricted from practice in any jurisdiction, may provide legal services in this jurisdiction on a temporary basis. Those legal services must arise out of and be reasonably related to that lawyer's practice of law in the jurisdiction, or area of such other jurisdiction, where the major disaster occurred.

(d) Duration of authority for temporary practice. The authority to practice law in this jurisdiction granted by paragraph (b) of this Rule shall end when this Court determines that the conditions caused by the major disaster in this jurisdiction have ended except that a lawyer then representing clients in this jurisdiction pursuant to paragraph (b) is authorized to continue the provision of legal services for such time as is reasonably necessary to complete the representation, but the lawyer shall not thereafter accept new clients. The authority to practice law in this jurisdiction granted by paragraph (c) of this Rule shall end [60] days after this Court declares that the conditions caused by the major disaster in the affected jurisdiction have ended.

(e) Court appearances. The authority granted by this Rule does not include appearances in court except:

(1) pursuant to that court's pro hac vice admission rule and, if such authority is granted, any fees for such admission shall be waived; or

(2) if this Court, in any determination made under paragraph (a), grants blanket permission to appear in all or designated courts of this jurisdiction to lawyers providing legal services pursuant to paragraph (b). If such an authorization is included, any pro hac vice admission fees shall be waived.

(f) Disciplinary authority and registration requirement. Lawyers providing legal services in this jurisdiction pursuant to paragraphs (b) or (c) are subject to this Court's disciplinary authority and the Rules of Professional Conduct of this jurisdiction as provided in Rule 8.5 of the Rules of Professional Conduct. Lawyers providing legal services in this jurisdiction under paragraphs (b) or (c) shall, within 30 days from the commencement of the provision of legal services, file a registration statement with the Clerk of this Court. The registration statement shall be in a form prescribed by this Court. Any lawyer who provides legal services pursuant to this Rule shall not be considered to be engaged in the unlawful practice of law in this jurisdiction.

(g) Notification to clients. Lawyers authorized to practice law in another United States jurisdiction who provide legal services pursuant to this Rule shall inform clients in this jurisdiction of the jurisdiction in which they are authorized to practice law, any limits of that authorization, and that they are not authorized to practice law in this jurisdiction except as permitted by this Rule. They shall not state or imply to any person that they are otherwise authorized to practice law in this jurisdiction.

Comment

[1] A major disaster in this or another jurisdiction may cause an emergency affecting the justice system with respect to the provision of legal services for a sustained period of time interfering with the ability of lawyers admitted and practicing in the affected jurisdiction to continue to represent clients until the disaster has ended. When this happens, lawyers from the affected jurisdiction may need to provide legal services to their clients, on a temporary basis, from an office outside their home jurisdiction. In addition, lawyers in an unaffected jurisdiction may be willing to serve residents of the affected jurisdiction who have unmet legal needs as a result of the disaster or, though independent of the disaster, whose legal needs temporarily are unmet because of disruption to the practices of local lawyers. Lawyers from unaffected jurisdictions may offer to provide these legal services either by traveling to the affected jurisdiction or from their own offices or both, provided the legal services are provided on a pro bono basis through an authorized not-for-profit entity or such other organization(s) specifically designated by this Court. A major disaster includes, for example, a hurricane, earthquake, flood, wildfire, tornado, public health emergency or an event caused by terrorists or acts of war.

[2] Under paragraph (a)(1), this Court shall determine whether a major disaster causing an emergency affecting the justice system has occurred in this jurisdiction, or in a part of this jurisdiction, for purposes of triggering paragraph (b) of this Rule. This Court may, for example, determine that the entirety of this jurisdiction has suffered a disruption in the provision of legal services or that only certain areas have suffered such an event. The authority granted by paragraph (b) shall extend only to lawyers authorized to practice law and not disbarred, suspended from practice or otherwise restricted from practice in any other manner in any other jurisdiction.

[3] Paragraph (b) permits lawyers authorized to practice law in an unaffected jurisdiction, and not disbarred, suspended from practice or otherwise restricted from practicing law in any other manner in any other jurisdiction, to provide pro bono legal services to residents of the affected jurisdiction following determination of an emergency caused by a major disaster; notwithstanding that they are not otherwise authorized to practice law in the affected jurisdiction. Other restrictions on a lawyer's license to practice law that would prohibit that lawyer from providing legal services pursuant to this Rule include, but are not limited to, probation, inactive status, disability inactive status or a non-disciplinary administrative suspension for failure to complete continuing legal education or other requirements. Lawyers on probation may be subject to monitoring and specific limitations on their practices. Lawyers on inactive status, despite being characterized in many jurisdictions as being "in good standing," and lawyers on disability inactive status are not permitted to practice law. Public protection warrants exclusion of these lawyers from the authority to provide legal services as defined in this Rule. Lawyers permitted to provide legal services pursuant to this Rule must do so without fee or other compensation, or expectation thereof. Their service must be provided through an established not-for-profit organization that is authorized to provide legal services either in its own name or that provides representation of clients through employed or cooperating lawyers. Alternatively, this court may instead designate other specific organization(s) through which these legal services may be rendered. Under paragraph (b), an emeritus lawyer from another United State jurisdiction may provide pro bono legal services on a temporary basis in this jurisdiction provided that the

emeritus lawyer is authorized to provide pro bono legal services in that jurisdiction pursuant to that jurisdiction's emeritus or pro bono practice rule. Lawyers may also be authorized to provide legal services in this jurisdiction on a temporary basis under Rule 5.5(c) of the Rules of Professional Conduct.

[4] Lawyers authorized to practice law in another jurisdiction, who principally practice in the area of such other jurisdiction determined by this Court to have suffered a major disaster, and whose practices are disrupted by a major disaster there, and who are not disbarred, suspended from practice or otherwise restricted from practicing law in any other manner in any other jurisdiction, are authorized under paragraph (c) to provide legal services on a temporary basis in this jurisdiction. Those legal services must arise out of and be reasonably related to the lawyer's practice of law in the affected jurisdiction. For purposes of this Rule, the determination of a major disaster in another jurisdiction should first be made by the highest court of appellate jurisdiction in that jurisdiction. For the meaning of "arise out of and reasonably related to," see Rule 5.5 Comment [14], Rules of Professional Conduct.

[5] Emergency conditions created by major disasters end, and when they do, the authority created by paragraphs (b) and (c) also ends with appropriate notice to enable lawyers to plan and to complete pending legal matters. Under paragraph (d), this Court determines when those conditions end only for purposes of this Rule. The authority granted under paragraph (b) shall end upon such determination except that lawyers assisting residents of this jurisdiction under paragraph (b) may continue to do so for such longer period as is reasonably necessary to complete the representation. The authority created by paragraph (c) will end [60] days after this Court makes such a determination with regard to an affected jurisdiction.

[6] Paragraphs (b) and (c) do not authorize lawyers to appear in the courts of this jurisdiction. Court appearances are subject to the pro hac vice admission rules of the particular court. This Court may, in a determination made under paragraph (e)(2), include authorization for lawyers who provide legal services in this jurisdiction under paragraph (b) to appear in all or designated courts of this jurisdiction without need for such pro hac vice admission. If such an authorization is included, any pro hac vice admission fees shall be waived. A lawyer who has appeared in the courts of this jurisdiction pursuant to paragraph (e) may continue to appear in any such matter notwithstanding a declaration under paragraph (d) that the conditions created by major disaster have ended. Furthermore, withdrawal from a court appearance is subject to Rule 1.16 of the Rules of Professional Conduct.

[7] Authorization to practice law as a foreign legal consultant or in-house counsel in a United States jurisdiction offers lawyers a limited scope of permitted practice and may therefore restrict that person's ability to provide legal services under this Rule.

[8] The ABA National Lawyer Regulatory Data Bank is available to help determine whether any lawyer seeking to practice in this jurisdiction pursuant to paragraphs (b) or (c) of this Rule is disbarred, suspended from practice or otherwise subject to a public disciplinary sanction that would restrict the lawyer's ability to practice law in any other jurisdiction.

HOT TOPICS:

FAMILY LIMITED PARTNERSHIPS

STEPHANIE LOOMIS-PRICE

BAKER BOTTS L.L.P.
One Shell Plaza
910 Louisiana
Houston, Texas 77002
713.229.1801
713.229.7801 (Fax)
s.loomis-price@bakerbotts.com

Presented at:

AMERICAN BAR ASSOCIATION
REAL PROPERTY, TRUST & ESTATE LAW'S
2007 FALL LEADERSHIP MEETING

October 18-21, 2007
Minneapolis, Minnesota

This material will be presented at the 42nd Annual Heckerling Institute on Estate Planning, scheduled for January 14-18, 2008 in Orlando, Florida. It is reprinted with the permission of the Heckerling Institute and the University of Miami. Further information on the Heckerling Institute is available at www.law.miami.edu/heckerling.

Table of Contents

I. Introduction

II. Consider Appropriateness of Partnership .

A. Keep Potential Future Audience in Mind

B. Consider Whether Clients Are Ready for Partnership

C. Evaluate Potential Assets

D. Evaluate Potential Partners

E. Engage/Consult with Experienced Advisors .

III. Partnership Formation

A. Consider Separate Counsel for Participants

B. Discuss Partnership Terms

C. Ensure Agreement's Schedules Are Complete .

D. Prepare Transfer Documents in Advance and File with Relevant State Authorities

E. File for Employer Identification Number

F. Create Partnership Accounts Timely

G. Engage Partnership Accountant

H. Reflect Contributions in Capital Accounts in Proportion to Fair Market Value of Assets Contributed

I. Consider Deducting Partnership Set-Up Fees

J. If Necessary, Amend Partnership Percentages as Quickly as Possible After Formation

K. Be Prepared to Produce Documents in Your File to the IRS, If Necessary

IV. Partnership Maintenance

A. Consider Filing Tax Returns for Each Year in Existence

B. File Any Required Annual/Bi-Annual Registration Statements

C. Comply with Terms of Partnership Agreement

D. Comply with Loan Terms, If Loans Are Made .

E. Distributions, If Made, Should Be Pro Rata

F. Refrain from Use of Partnership Assets for Partners' Personal Obligations

G. Upon Transfers, Consider Whether to Make Section 754 Election

H. Avoid Irregular Transactions Between Partners and Partnership

I. Keep in Mind Non-Tax Reasons Stated for Forming Partnership

V. TRANSFERS OF PARTNERSHIP INTERESTS

A. Generally

B. By Gift

C. By Sale

D. At Death

E. By Redemption

VI. TRANSFER TAX REPORTING

A. Obtain Appraisal from Independent Qualified Appraiser

B. Confirm with the Appraiser the Interest to Be Valued

C. Consider Whether to Aggregate Interests .

D. Review Appraisal Closely for Facts

E. Try to Live by Factual Information Provided to Appraiser

F. Beware of Rounding on Appraisals and Tax Returns

G. Understand IRS Settlement Guidelines

VII. AUDIT

A. Consider Bringing in Litigation Counsel

B. Determine Whether a Document Destruction Policy Exists; If So, Suspend

C. Consider the Burden of Proof D. Consider the Impact of Privileges

E. Consider Whether Production of Privileged Information May Help

Your Case

F. Provide Responses to the IRS that Are True and Correct, to the Best

of Your Knowledge

G. Keep in Mind that Anything Stated or Written Can Be

Treated as an Admission

H. Produce Responsive Documents in Your Possession, Custody, or Control

I. Keep Careful Track of Documents and Electronic File Produced

to the IRS

J. Understand the IRS's Broad Subpoena Power

K. File Protective Claims If Necessary

L. Consider Whether it is Feasible to Keep Partnership in Place

M. Treat Informal Interviews as Depositions .

Introduction

The steps that partners and their advisors take in forming and operating a family limited partnership can impact a court's view on valuation to such a great extent that valuation evidence can become irrelevant. In transfer tax cases addressing legal issues such as indirect gifts and the applicability of Internal Revenue Code ("I.R.C.") § 2036, courts may conclude that the facts in a given case are such that it is a proportionate share of the assets of the partnership, rather than the transferred partnership interest, that is to be valued for transfer tax purposes. In other words, if the existence of the partnership is judicially disregarded, the question of value of the transferred partnership interest need not be reached – only the value of the underlying assets of the partnership matters. The result to the taxpayer in such a situation is that although he may have transferred a partnership interest, which interest carries with it the duties and restrictions found in the governing partnership agreement (and thus, in determining the fair market value of that interest, discounts for lack of marketability and lack of control should be applied), for transfer tax purposes, those duties and restrictions are ignored, and the resulting discounts disregarded. Thus, when the existence of a partnership is judicially ignored, the value that is used for transfer tax purposes is the portion of the underlying assets of the partnership attributable to the transferred interest, without regard to the fact that a hypothetical buyer would take into account the terms of the partnership agreement when deciding on the price that he would be willing to pay for the interest.

In determining fair market value for transfer tax purposes, the value of a transferred interest to be transferred is determined according to the "hypothetical willing buyer/willing seller" test found in I.R.C. § 2031 (for estate tax purposes) and § 2512 (for gift tax purposes) and the related Treasury Regulations. But the fair market value of the transferred interests is not a proportionate share of the partnership's assets, because a hypothetical willing buyer would not be willing to pay for a pro rata share of the underlying assets of the partnership, in part because the buyer would not own the underlying assets and in part because the terms of the partnership agreement burden the assets. Consequently, the fair market value of a partnership interest is almost certain to be less than the proportionate value of the assets of the partnership. And it is the fair market value *of the transferred partnership interest* that is used to determine the amount of tax due as a result of the transfer.

However, in some circumstances, the Internal Revenue Service ("the IRS") has argued, and the courts have agreed, that the existence of a partnership should be, in essence or in fact, ignored. This article is intended to assist practitioners in advising their clients at each step of forming, operating, and defending a partnership to avoid pitfalls that the courts and the IRS are pointing to when opining that, in essence, the existence of a partnership should be disregarded for valuation purposes.

Consider Appropriateness of Partnership

Keep Potential Future Audience in Mind

Planning for the estate tax examination really begins at the estate planning level. Keep in mind that anything that you write (even if protected from discovery by one or more privileges) may later be viewed by the IRS, a judge, or even a jury. For instance, in cases where the IRS has asserted that I.R.C. § 2036 applies (and thus the client has passed away), the only evidence of non-tax reasons for forming a partnership may be found in the advisors' files. While advisors should not shy away from explaining the tax effects of forming a limited partnership, it is preferable to have such discussions take place in the context of a discussion of the non-tax reasons, as well.

Consider Whether Clients Are Ready for Partnership

Family limited partnerships are like blowfish sushi – handled with precision and care, they can be wonderful; handled carelessly, they are downright dangerous. Family limited partnerships can be confusing, but at a minimum, they are complex. In that regard, it is important to evaluate whether the people who are considering forming a family limited partnership are up to the task. Can they get along? Are they willing to abide by the rules? Are they prepared to pay the legal and accounting fees that tend to come along with the entity? These questions and others are important to address in determining whether your clients are ready for a partnership.

Evaluate Potential Assets

The courts and the IRS have opined that partners should retain enough assets outside of the partnership to support their lifestyles. The IRS is fond of asserting that a contributing partner's failure to retain sufficient assets outside of a partnership to maintain his or her standard of living is evidence of an implied agreement of that partner to retain rights to the income from the assets contributed to the partnership. *See Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003). In combating, for instance, an I.R.C. § 2036 argument, it is helpful to have contemporaneous documentation of the fact that a contributing partner had sufficient cash flow outside of the partnership to support his or her lifestyle without depending on extraordinary distributions from the partnership.

In determining whether formation of a partnership is appropriate, partners should consider the nature of the assets to be contributed to the partnership. For instance, the IRS and the courts have, in their consideration of whether a partnership is to be respected, considered as a negative factor the contribution of "personal use" assets to partnerships. *See, e.g,Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003). Such assets include personal residences, vacation homes, and recreational equipment. If the partners feel strongly about contributing such assets to the partnership, care should be taken to avoid IRS attack by ensuring that the partnership is compensated for individuals' (including and perhaps most importantly, partners') use of those assets, *i.e.*, rent should be paid to the partnership for use of the partnership's assets. Failure to do so may lead the IRS to assert, for instance, that I.R.C. § 2036 should apply at death, in light of the fact that a contributing partner maintained the right to use partnership property without paying for it.

In recent cases, the courts have examined the propriety of partners' capital accounts on formation as a factor in whether I.R.C. § 2036 should be applied to various partnership interest transfers. In that regard, advisors should keep the full and adequate consideration element of the exception to I.R.C. § 2036 in mind and ensure that capital accounts of all partners are properly created, credited, and maintained. Consequently, if partners intend to contribute assets to the partnership that are hard to value (*i.e.*, real estate, oil and gas interests, interests in closely held entities), it is advisable to obtain appraisals of the fair market value of those assets so that the calculation of initial ownership interests in the partnership is as accurate as possible.

Likewise, if assets subject to debt or non-liquid assets (such as real estate) are to be contributed to the partnership, the partners should make sure to fund the partnership with sufficient cash to support those assets, such that the partnership can service its debt and pay real estate taxes related to its property. Doing so may help to minimize fuel for an IRS argument that a contributing partner's debt service or payment of maintenance costs related to assets contributed to the partnership evidences an implied agreement under I.R.C. § 2036 of that partner's right to use those partnership assets.

Finally, when determining which assets are to be contributed to the partnership, it is important to review any transfer restrictions that might be applicable to those assets. If the documents governing a particular asset do not permit transfer of that asset without, for instance, written authorization of a certain person or entity, it is important to begin that authorization process sooner rather than later (or to avoid contributing that asset to the partnership, if it is determined that that transfer restrictions are too onerous).

Evaluate Potential Partners

First, potential partners should consider with whom they wish to be partners. Family limited partnerships often have long terms of existence. It is a good idea to consider whether partners think that they will be able to work together throughout the term of the partnership. Evidence of discussion of such considerations is helpful in establishing that the terms of the partnership agreement were negotiated, a factor that is considered, for instance, in determining whether the bona fide sale element of the exception to I.R.C. § 2036 is applicable.

On a similar note, participants should consider the health of their proposed partners. The IRS likes to point to "deathbed partnerships" as evidence of its assertion that the only reason for forming the partnership was tax avoidance. If one or more of the potential partners is seriously ill, the partners might reconsider whether to include her. *See, e.g.,Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000) (bad health); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003) (bad health); *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003) (good health). And beware forming a partnership with a person who is not competent to execute the partnership agreement himself; when determining whether partnerships were formed for bona fide, non-tax reasons, the IRS and the courts have taken into account the fact that an agent, rather than the partner, executed the formation documents. *See, e.g.,Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003); *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003).

Second participants should consider whether the partners will be individual family members, trustees of trusts for family members, entities formed by family members (such as a limited liability company, or "LLC"), or some combination of any or all of the above.

In choosing partners, the participants should consider who will be able to make meaningful capital contributions to the partnership. *SeeEstate of Bongard v. Comm'r*, 124 T.C. 95 (2005). To the extent possible, it is preferable to have each partner make a meaningful contribution to the partnership so as to establish that a real pooling of assets and services occurred and to avoid the IRS's argument that, for instance, a child's proportionately small contribution had no real impact – that creation of the partnership was a "mere recycling of value," as that term is used in *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002). (Beware, though, the implications of the investment company rules when determining the nature and amount of the assets to be contributed to a partnership.) *See, e.g.*, I.R.C. §§ 721, 351, 368.

Finally, in determining who the partners will be, forming partners should consider what roles each of the partners will play, if any, in partnership management. Do the partners intend to have the parent manage the partnership? Is the partnership to be used as a tool to progressively teach the next generation? Or is management to be passed immediately to the children? A parent's considerations in this regard and a written record of those considerations can play a pivotal role in later establishing the non-tax reasons for which a partnership was formed.

Engage / Consult with Experienced Advisors

It is important to hire an attorney and an accountant who are experienced in family limited partnership issues to assist in the decision-making processes, and hiring such advisors should happen sooner rather than later. The earlier that experienced advisors are is involved, the less likely the partners are to make a misstep in what can be a convoluted process. Beware simplified "kit" partnerships that do not take into account the partners' individual reasons for and goals in forming the partnership. *See, e.g.*, *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002).

Partnership Formation

In the IRS's view, and more importantly, that of the courts, it is critical that partners in a partnership respect the entity as an entity (*i.e.*, comply with the terms of the governing partnership agreement, treat assets of the partnership as partnership assets, etc.). If the partners fail to do so, it is highly unlikely that the IRS or a court will. In that regard, it is important to dot all of the Is and cross all of the Ts. Some suggestions follow:

Consider Separate Counsel for Participants

Although implementation of this suggestion can be expensive, having each partner represented by separate counsel goes a long way toward ensuring that the interests of each partner are considered when forming the partnership and that the terms of the partnership agreement will be reviewed by and discussed among the partners at that time. It also serves to evidence the arm's-length nature of the creation of the partnership. *See Estate of Stone v. Comm'r*, 86 T.C.M (CCH) 551 (2003).

Discuss Partnership Terms

In establishing that the creation of the partnership is a bona fide sale as that term is used in I.R.C. § 2036, it is important to document any facts evidencing the arm's-length nature of the transaction. Negotiation of the terms of the partnership agreement by the intended partners is precisely the type of evidence that can be used to establish that the bona fide sale element of the I.R.C. § 2036 exception is met, as was the case in *Estate of Stone v. Comm'r*, 86 T.C.M (CCH) 551 (2003). (Using a "kit" partnership may play into the hands of the IRS, as such pre-formulated documents rarely leave room for the tailoring that an attorney with experience in family partnerships can provide. *See, e.g., Estate of Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002).

Some of the partnership agreement terms that family members might consider important to negotiate and discuss in this regard are:

Purpose – what are the family-specific reasons that this taxpayer and her family have for forming the partnership?;

Management structure – who will serve as general partner(s)? Will there be a managing partner(s)? Will unanimity be required for management decision-making if more than one person or entity is managing the partnership?;

Management powers – what actions may partnership management take without the approval or input of the other partners?;

Compensation to managers – will the general partners/managing partners be

compensated? If so, at what level?;

Investment policy – what will the partnership's investment policy be?;

Distribution policy – will the partnership make regular distributions? Will it make distributions sufficient to cover each partner's income tax liability attributable to his partnership interest?;

Transfer restrictions – what transfer restrictions should be included in the partnership agreement? How will those transfer restrictions impact each partner?;

Partnership term – how long should the partnership stay in existence?; and

Use of partnership assets – under what terms may a partner or third party rent a partnership asset?

Ensure Agreement's Schedules Are Complete

Most partnership agreements refer to an attachment, schedule, or exhibit that is intended to list all of the assets that the partners agree to contribute to the partnership at formation and the resulting partnership interests to be received by the partners in return. In some states, such attachments are required by statute; and in some of those states, the attachments must also detail the fair market value of the assets to be contributed. In combating IRS arguments that the formalities of a partnership were not respected, it is important that any such attachments to a partnership agreement be complete at the time that the partnership agreement is signed. And in order to best anticipate questions in audit, such attachments should accurately set forth the assets contributed to the partnership, the fair market value of those assets, and the resulting ownership interests of each partner of the partnership.

Sometimes it is impossible to know the fair market value of contributed assets – and thus the amount of the resulting percentage interests – at the time that the partnership agreement is signed. This situation can occur if, for instance, there are hard-to-value assets such as real estate for which an appraisal as of the formation date is being obtained. This can also occur with regard to securities, for which the value cannot be known until the close of business on the day of formation. If necessary, an amendment to the partnership agreement can be executed once accurate fair market values are known.

Prepare Transfer Documents in Advance and File with Relevant State Authorities

As referenced above, in disputing the IRS's assertions that a partnership should not be respected, it is important to establish that the formalities surrounding formation (and operation) of a partnership are respected. One of those formalities is the transferring of assets to the partnership that the partners agreed to contribute when creating the partnership. In that regard, it is most efficient to have the transfer documents ready at the time that the partnership agreement is signed, so that partners can sign all of the relevant documents necessary to form the partnership agreement and transfer title to the assets into the partnership's name all at once. Doing so also ensures that this very important step does not get overlooked.

Typically, a limited partnership is not formed until a Certificate of Limited Partnership or similar document is filed with the relevant state authority (often, the Secretary of State). Be sure to file such required documentation with the state (and obtain any state licenses or registrations) timely. Delays between the date that a partnership agreement is executed and the date that the partnership is actually formed under state law can be problematic when the IRS gets involved. *See, e.g., Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002); *Estate of Erickson v. Comm'r*, 93 T.C.M. (CCH) 1175 (2007); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002).

File for Employer Identification Number

Likewise, in order to avoid IRS attack, once a partnership is formed, it is important to apply to the IRS for a federal employer identification number ("EIN") as quickly as possible, *e.g.*, as soon as the certificate of limited partnership is filed and returned by the relevant state authority. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, *Turner v. Comm'r*, 382 F.3d 367 (3rd Cir. 2004). As with the failure to timely file certificates of limited partnership, the IRS has pointed to delays in obtaining EINs as evidence that partnership formalities were not respected.

Create Partnership Accounts Timely

It is important to set up partnership bank and brokerage accounts and transfer contributed assets to those accounts as soon as possible after formation for two reasons: first, to establish that the partnership entity is being respected by its partners and the partners understand that the partnership's assets are just that – partnership assets; second, to ensure that any income earned on partnership assets is credited to the partnership – not to the contributing partner. Otherwise, the door is left open for the IRS to assert the applicability of I.R.C. § 2036, on the grounds that the contributing partner had an implied agreement to retain the income from the assets contributed to the partnership. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'dTurner v. Comm'r*, 382 F.2d 367 (3rd. Cir. 2004).

Engage Partnership Accountant

Accounting issues can make or break a court's view of whether to respect the existence of a partnership. In that regard, it is important to hire an experienced partnership accountant who has knowledge of, among others, such partnership issues as capital accounts, the impact of distributions on partners' basis in their partnership interests, the impact of additional capital contributions, redemptions, and sales on ownership interests, I.R.C. § 754 elections, protective claims, and audit procedures, etc.

Reflect Contributions in Capital Accounts in Proportion to Fair Market Value of Assets Contributed

This step is critical in establishing the existence of proof that a transfer of assets in exchange for partnership interests was for full and adequate consideration, as that term is used in the exception to the application of I.R.C. § 2036, or was not an indirect gift of the assets contributed to the partnership. To avoid IRS attack, each partner's capital account should reflect the value of the assets that he contributed to the partnership and the percentage interest received by the partner in return. In order to refute the application of, among other theories, I.R.C. § 2036, the percentage interests received by the partners should be proportionate to the fair market value of the assets that each contributed.

Consider Deducting Partnership Set-Up Fees

The IRS consistently examines the identity of the payor of partnership set-up fees. If a partner has paid the legal and accounting fees related to creation of the entity and has not been repaid by the partnership, the IRS typically asserts that the partnership has not been respected; that, if it were truly a business entity (and not merely an entity created for tax avoidance purposes), the paying partner would have sought reimbursement by the partnership. Keep in mind that a partnership that pays for (or reimburses) set-up fees may, in most cases, deduct those fees for income tax purposes, although, depending on the amount, it may have to do so by way of amortizing them.

If Necessary, Amend Partnership Percentages as Quickly as Possible After Formation

In order to minimize IRS attack, if assets were contributed to the partnership but the precise fair market value of some or all of those assets was not known on the date of formation (as is likely to be the case with hard-to-value assets such as real estate or mineral interests), the partnership agreement (or its attachments) should be amended as soon as information on all contributed assets becomes available. If such amendments are not made, the IRS is likely to assert that the capital accounts of the contributing partners are not proportionate to the fair market value of the assets contributed and, as a result, the exception to I.R.C. § 2036 cannot apply.

Be Prepared to Produce Documents in Your File to the IRS, If Necessary

The best evidence of a taxpayer's rationale for forming a partnership often comes from the correspondence prepared in connection with the decision to create the entity. In that regard, it is important always to keep the potential audience in mind as communications among the partners and their advisors occur. In attempting to establish the non-tax reasons for forming a partnership, it is helpful if the documentation is such that the taxpayer feels comfortable waiving the attorney-client privilege and producing requested communications that would otherwise be protected from discovery under the attorney-client privilege. Further, keep in mind that assertion of privileges may lead to negative inferences by the IRS.

Partnership Maintenance

Consider Filing Tax Returns for Each Year in Existence

It seems common sense – a legal entity has been established; thus, at the appropriate time, a tax return for the partnership must be filed, right? But what if the entity is formed on December 27? Should a tax return for those 4 days be filed? And what if the entity has no income for the first two or three years that it exists (perhaps it holds only cash and non-income producing real estate, or non-dividend paying stock)? What then?

In both examples, it may be tempting to forgo filing an income tax return. However, to minimize avenues of IRS attack, it is advantageous to file, despite the apparent lack of necessity to do so. First, partnerships often rely on the information contained in the partnership income tax return to document partners' capital accounts. If no partnership income tax return is filed in the partnership's first year of existence, it may be difficult to evidence that the capital accounts were properly created, reflecting the proportionate exchange of assets for partnership interests. Second, even if the partnership has no income, the IRS has been known to assert that the failure to file an income tax return reflects the partners' intent in forming the partnership only as a transfer tax device. Consequently, despite the fact that doing so may seem unnecessary, it is advisable to file income tax returns for partnerships consistently from inception.

File Any Required Annual/Bi-Annual Registration Statements

It is important to maintain the partnership in good standing with the relevant state authorities. It is not uncommon for IRS litigators, as their first step in reviewing a transfer tax case, to check with the state authorities for all documents on file for the relevant partnership. It is often at this stage that it is first discovered that an entity's good standing has been revoked for the simple failure to send in annual updates or confirmations of the partnership's address. When such revocations occur, even if for very short periods, the IRS likes to argue that such lapses indicate that the entity is an entity without any purpose other than transfer tax avoidance.

Comply with Terms of Partnership Agreement

This suggestion seems only common sense. However, the IRS likes to go through partnership agreements with a fine-toothed comb. If the partners have not themselves done so, they may have neglected to comply with some of the more straightforward requirements of the partnership agreement. Consider reading the partnership agreement with a fresh eye and making a list of all periodic administrative requirements. For instance, are regular meetings required? If so, in light of the IRS's frequent assertions that partnerships are nothing other than transfer tax avoidance devices, partners might choose to take minutes, even if not required (although continuing to keep in mind the eventual potential audience), to establish the business approach taken by the partnership. Are annual statements (other than tax returns) required? Are annual distributions required? Are payments on preferred interests required? Is documentation of the partners of the partnership required to be kept in a certain manner? In order to avoid IRS attack, it is important to ensure that partners treat the entity as a business entity and comply with the terms governing that entity.

Comply with Loan Terms, If Loans Are Made

Beware of lending from the partnership to family members. The IRS and the courts have not looked kindly on partnerships where such loans were made, particularly where the terms of the loans were either undocumented or, where documented, were not complied with. To minimize IRS attacks, any loans made by the partnership should be properly documented and should comply with the terms of the governing partnership agreement. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd, Turner v. Comm'r*, 382 F.3d 367 (3rd Cir. 2004). Loan terms should be reasonable, and payments should be made timely. In addition, both the partnership and the debtor should comply with the terms of the loans, including foreclosure, if necessary. As noted in various discussions in this chapter, it is important to treat the partnership for what it is – a separate, legal entity.

Distributions, If Made, Should Be Pro Rata

In order to minimize avenues of IRS attack, and assuming that the partnership agreement requires pro rata distributions (as most do), make sure that any distributions made by the partnership are proportionate to the percentage interests held by the partners in the partnership. In cases under IRS scrutiny where non-pro rata distributions have been made (typically to the parent partner), the IRS has typically argued that the partner receiving distributions retained rights to the assets contributed to the partnership such that I.R.C. § 2036 applies. If a non-pro rata distribution has been made, consider making “make-up” distributions to the remaining partners, perhaps with interest at a reasonable rate.

Refrain from Use of Partnership Assets for Partners’ Personal Obligations

Once contributed to the partnership, partnership assets belong to the partnership – not to the contributing partner and not to any of the other partners. Consequently, in order to avoid IRS scrutiny, it is important that partnership assets be treated as such. Where partners may have used partnership funds to pay for their individual expenses or used partnership real estate without contemporaneously paying rent, the IRS has often asserted the application of I.R.C. § 2036, on the grounds that there was, at a minimum, an implied agreement that the contributing partner retained the right to use the assets contributed. As discussed above, where I.R.C. § 2036 is held to apply, the existence of the partnership is essentially disregarded, and evidence as to the value of a transferred partnership interest becomes irrelevant, as it is the value of the underlying assets, rather than the partnership interest itself, on which the transfer tax is imposed.

As indicated above, it is important to keep the partnership’s assets separate from the partners’ assets. This suggestion applies as well at the death of any of the partners. Often, death causes financial hardship, in that a decedent’s assets may be frozen for the time between date of death and the date that a personal representative for the estate is appointed. If expenses of the decedent must be paid in the interim, and no one has access to the decedent’s assets, the partnership’s checking account should not be used to pay those expenses. (In such cases, despite objections that post-death facts are irrelevant to valuation of the decedent’s partnership interests, the IRS has argued that the fact that partnership funds were used to pay a decedent taxpayer’s debts is evidence of an implied agreement by the decedent to retain the right to use assets contributed to the partnership, such that I.R.C. § 2036 should apply.) If absolutely necessary, the partnership may wish to make a loan to the estate of the decedent so that the estate’s representative can take care of business. Alternatively, perhaps beneficiaries of the estate or a third-party lending institution could loan funds to the estate.

Upon Transfers, Consider Whether to Make Section 754 Election

Many factors should be taken into account when determining whether an I.R.C. § 754 election should be made when an interest in a partnership is transferred (whether by sale, by gift, or by transfer at death). One such consideration, however, is whether any transfer tax return related to the transfer may be audited by the IRS. If the return is audited, to the extent that it is finally determined that the value of any partnership interest is greater than the value reported on the estate tax return, an election by the partnership under I.R.C. § 754 may be advantageous, as it could apply to cause a step-up in the partnership’s inside basis in the decedent’s proportionate share of the partnership’s assets. Thus, any finally determined increase in value of the decedent partner’s partnership interest, where such an election has been made, may allow the partnership to seek an income tax refund related to sales of partnership assets since date of death, as any capital gains related to such sales will have been reduced. (Keep in mind that protective claims may need to be filed if the statute of limitations is close to running on the income tax returns but the examination of the transfer tax return has not been completed.)

Avoid Irregular Transactions Between Partners and Partnership

When asserting that I.R.C. § 2036 should apply, the IRS looks for any facts that it can find to indicate an implied agreement that a taxpayer retained rights related to assets transferred to a partnership. For example, where a partnership has redeemed numerous partnership interests held by a partner, or made multiple loans, non-regular distributions, or non-pro rata distributions to that partner, the IRS may argue that the facts indicate an implied agreement that the taxpayer retained rights to the assets that he transferred to the partnership, such that I.R.C. § 2036 should apply to, in effect, disregard the existence of the partnership for valuation purposes. In order to avoid such arguments by the IRS, numerous transactions of this type between the partnership and its partners should be avoided.

Keep in Mind Non-Tax Reasons Stated for Forming Partnership

As the partnership grows and the partners develop a working relationship, keep in mind the non-tax reasons that were given for forming the partnership at the outset. To the extent possible, try to implement them. Doing so can help undercut an IRS attack that the partnership was formed only for tax savings.

TRANSFERS OF PARTNERSHIP INTERESTS

Generally

When partnership interests are transferred, it is a good time to review the books and records of the partnership to ensure that they are in order. Due diligence at this stage (and at all others) bolsters the position that the partnership is a respected, stand-alone entity.

Regardless of the nature of the transfer, it is also important to consider whether a transfer of a partnership interest triggers any rights of first refusal; if so, it is important in warding off IRS attacks to comply with any such transfer restrictions.

In general, it is helpful at the audit stage in particular if partnership management (and its accountants) have kept careful track of changes in partnership interests (perhaps through keeping a historical spreadsheet outlining each transfer of partnership interests) and to update the partnership books and records to reflect any such changes. Doing so concurrently with transfers assists at the audit level, as such a record provides contemporaneous evidence of the transfers and can, again, bolster the position that the partnership is an entity separate from its partners. If necessary, consider restating the applicable schedule or exhibit to the governing partnership agreement to reflect the change.

Regardless of the nature of the transfer, it is important to document the transfer of partnership interests. In order to minimize IRS attacks, such transfer documents should be executed by transferor and transferee, and the document should be dated on the date that they are signed (though the effective date may be different).

Finally, ensure that the Certificate of Limited Partnership for the partnership is amended, if necessary, and filed with the relevant state authority. Failure to do so may give the IRS room to argue that the entity was not respected by its partners.

By Gift

In addition to the considerations discussed in paragraph A above, when the transfer is to occur by gift, it is important to refrain from gift planning until the partnership is formed and operating in order to avoid the indirect gift theory discussed above. *See, e.g., Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

By Sale

When a transfer occurs by sale, be sure to consider the income tax implications of such a transfer.

At Death

When the transfer of partnership interests occurs as a result of a partner's death, it is especially important to review the transfer to determine whether a lapse occurs under Chapter 14 of the Internal Revenue Code and to report the interest transferred accordingly. While many partnership agreements are written with an eye toward avoiding the application of Chapter 14, not all have incorporated this concept.

Further, in order to simplify estate administration and potential audit, consider maintaining the partnership interest in the hands of the Executor, subject to estate administration, until a closing letter is received from the IRS. Once an IRS closing letter is received and the partnership interest is to be transferred into the hands of the appropriate beneficiary, document the transfer from the estate to the beneficiary, and that transfer document should be executed by both the executor and the recipient beneficiary.

By Redemption

When a partnership interest is transferred by way of redemption from a partner by the partnership, be sure to review the partnership agreement to ensure that the partnership is not prohibited from redeeming the interest from the interest holder. Next, be sure to document the redemption, to be executed by partnership management and the transferring partner. Finally, be sure that the books and records of the partnership reflect a decrease in the transferring partner's interest and a corresponding proportionate increase to all remaining partners' interests. Taking these steps will help avoid IRS attack.

TRANSFER TAX REPORTING

In order to ensure that any transfer tax return, whether Form 706 or Form 709, is prepared in a manner that is most defensible in audit, the taxpayer should engage an experienced attorney or accountant to prepare such returns.

Obtain Appraisal from Independent, Qualified Appraiser

To minimize IRS attack, the taxpayer should select an appraiser who will provide an independent and qualified appraisal of fair market value of the transferred interest. In that regard, consider whether the selected appraiser is independent from the taxpayer, is credible, is experienced in the area of partnership valuation, and has the appropriate certifications. Perhaps most importantly, the appraiser should not act as an advocate for the taxpayer.

Confirm with the Appraiser the Interest to Be Valued

Depending on the terms of the partnership agreement and the identity of the transferee, the interest transferred by the taxpayer may be a general partnership interest, a limited partnership interest, or an assignee interest in a limited partnership interest (and, depending on the terms of the partnership agreement, there may be classes within one or more of these types). It is important to identify the nature of the interest transferred, as each type carries with it specific rights and responsibilities that are likely to impact value.

Consider Whether to Aggregate Interests

If the transferred partnership interests include more than one class (*i.e.*, general partnership interests *and* limited partnership interests), be sure to clarify with the appraiser as to whether those interests should be aggregated for valuation purposes. For instance, if a general partnership interest and a limited partnership interest are transferred by the decedent, it is likely that the interests should be aggregated. If, however, the general partnership interest is held by the decedent, and the limited partnership interest is held in a marital trust created by the decedent's pre-deceasing spouse, the taxpayer may be able to take the position that the interests should *not* be aggregated. *See, e.g.,Estate of Bonner v. United States,* 84 F.3d 196 (5th Cir. 1996); *Estate of Bright v. United States,* 658 F.2d 999 (5th Cir. 1981).

Review Appraisal Closely for Facts

In opining as to fair market value, the appraiser will likely take into account numerous partnership-specific facts, such as the terms of the governing partnership agreement, the fair market value of the partnership's underlying assets, cash flow to the partnership, and the distribution policy of partnership management. As a result, when reviewing the appraiser's conclusions, it is important to confirm that the appraiser has properly reflected these facts in his report so that his valuation conclusions are not based on incorrect factual assumptions. (It is also helpful to make sure that a copy of the partnership agreement is included with the final appraisal, perhaps as an exhibit.)

Try to Live by Factual Information Provided to Appraiser

Once the appraiser has completed his appraisal, it is helpful in defending his conclusions if, after the valuation date, the partnership is operated in the manner reported to the appraiser, for example, in such areas as the distribution policy, anticipated cash flow, etc. Arguably, post-valuation date facts are irrelevant to valuation conclusions. However, the IRS may assert that deviation from the factual assumptions by the appraiser indicate that the appraiser's conclusions were faulty, especially if the partners anticipate at the time of the transfer that such a transaction might occur. Living with the factual information provided to the appraiser may help avoid such assertions.

Beware of Rounding on Appraisals and Tax Returns

If there is a reason to round value up or down, be sure that the appraiser explains his reasons in the appraisal. If the appraiser cannot explain why the value should be rounded up or down, he likely will not be able to do so on the stand either. And the courts are increasingly examining and parsing practically each and every valuation conclusion of appraisers of limited partnership interests. Unexplained rounding may cause a court to question other conclusions that the appraiser has made in the appraisal.

Understand IRS Settlement Guidelines

In early 2007, the IRS issued new settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal was to promote consistency of approaches across different jurisdictions and that its primary modes of attack would be the indirect gift theory and I.R.C. § 2036. *See* Settlement Guidelines, 07 No. 020 BNA Taxcore 25.

AUDIT

Consider Bringing in Litigation Counsel

Once the audit begins, it is particularly helpful to involve litigation counsel sooner rather than later. Doing so allows the litigator to be involved from step one, assisting in determinations related to the assertion or waiver of various privileges, responsiveness of documents and information, and consideration of the eventual burden of proof under I.R.C. § 7491.

Determine Whether a Document Destruction Policy Exists; If So, Suspend

Some corporate trustees and executors have document destruction policies. It has become advisable for attorneys whose clients are involved in litigation to ensure that their clients suspend document destruction policies. The consequence of failure to do so may include sanctions against the attorney and the client for spoliation of evidence. *See, e.g.*, *Phoenix Four, Inc., v. Strategic Resources Corp* ., 2006 WL 1409413 (S.D.N.Y.).

Consider the Burden of Proof

Until the late 1990s, the burden of proof in a tax case fell on taxpayers. In other words, if a court could not decide who should win in light of the evidence, the IRS won. For examinations beginning after July 22, 1998, however, it became possible for taxpayers in certain circumstances to shift the burden of proof to the IRS, so that if a court could not decide who should win in light of the evidence, the taxpayer would win. Under I.R.C. § 7491, if a taxpayer (who is not a partnership, corporation or trust) maintains all required records under the Code and complies with the IRS's reasonable requests for documents, information, and interviews, the burden of proof shifts to the IRS, and if a court cannot decide, the taxpayer wins. Although cases in which a court weighs the evidence and still comes down on the fence are very rare, the IRS has, in recent years, been very reluctant to agree that taxpayers meet the factual requirements of I.R.C. § 7491.

Consider the Impact of Privileges

Various privileges apply in the context of estate planning, the most familiar of which is the attorney-client privilege (often referred to simply as "the privilege"). Keep in mind that the privilege is the client's to waive, not the attorney's. As a general rule, the privilege covers client communications made to the attorney with the purpose of seeking legal advice.

The work-product doctrine, on the other hand, protects an attorney's thoughts and work *in preparation for litigation*. Contrary to common misconception, the work-product doctrine only begins to apply to an attorney's work that is done "in anticipation of litigation." According to the Seventh Circuit, audit can be the antechamber to litigation, and thus, the work-product doctrine may apply to an attorney's work even during the audit process. *See United States v. Frederick*, 182 F.3d 496, 502 (7 th Cir. 1999).

More recently, the U.S. Congress enacted a new federal privilege under I.R.C. § 7525 – the tax practitioner's privilege. This privilege applies only in non-criminal tax cases, and it protects from discovery communications that, if communicated to an attorney, would have been protected from discovery under the attorney-client privilege. Note, however, that in some jurisdictions, the tax practitioner's privilege has been interpreted not to cover advice related to tax return preparation. *See United States v. Frederick*, 182 F.3d 496 (7 th Cir. 1999).

While privileges can be waived, and often waiver is highly recommended (particularly in cases where the IRS is asserting the application of I.R.C. § 2036), beware of subject matter waiver. Once the privilege has been waived on a particular subject matter, that waiver covers all communications on that subject matter. Unfortunately, one cannot just pick and choose to waive the privilege with regard to favorable documents.

Consider Whether Production of Privileged Information May Help Your Case

Various privileges may apply in any given situation – the attorney-client privilege; the work product doctrine; and the tax practitioner's privilege under I.R.C. § 7525. As discussed above, however, there are often times when, if appropriate, it is helpful if the taxpayer waives such privilege, such that documents and information that would otherwise be protected from discovery is produced. This is particularly true in estate tax cases, where the best person with personal knowledge is the decedent taxpayer – and is not available to testify.

Provide Responses to the IRS that Are True and Correct, to the Best of Your Knowledge

The taxpayer's duty is to provide responses to IRS requests that are true and correct to the best of the taxpayer's knowledge. However, the taxpayer need only produce responsive documents in his possession, custody, or control; generally, there is no need to *create* documents to respond to IRS requests. If necessary, indicate in responding to the IRS that the taxpayer has no such documents in his possession, custody, or control that are responsive to the request.

Keep in Mind that Anything Stated or Written Can Be Treated as an Admission

As mentioned several times above, it is important to keep in mind that a judge or a jury might eventually read what is written related to the taxpayer's planning. Anything stated or written to the IRS at this stage can be treated as an admission. Further, anything written to the appraiser or any expert may be discoverable by the IRS.

Produce Responsive Documents in Your Possession, Custody, or Control

It is the taxpayer's duty to produce responsive documents in his possession, custody, or control. While documents held by the taxpayer's attorney, accountant, or bank are likely to be construed as within his possession, custody, or control, documents held by others may not. Be sure to consider the relationship between the taxpayer and the advisor in analyzing this issue.

Be precise when responding to the IRS. For instance, if the partnership owns primarily real estate, but has a small equity portfolio, be sure to disclose the existence of both (and in detail) when asked by the IRS for the assets of the partnership.

Keep Careful Track of Documents and Electronic File Produced to the IRS

Particularly if litigation counsel becomes involved at some point, it is helpful to have a precise record of the documents and electronic files that have been provided to the IRS, from inception of the audit through the close of discovery. In that regard, consider Bates-labeling every page produced to the IRS, such that there is a number associated with every page. (Doing so also helps in the stipulations process, as each exhibit can be identified by Bates-label number, ensuring that everyone (including the judge) is literally on the same page.)

Understand the IRS's Broad Subpoena Power

The IRS has a very broad power to subpoena practically any information, books, and records that it deems necessary to carry out is mission. The IRS may examine or summons a laundry list of items and people for the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax." I.R.C. § 7602(a). As might be expected, however, this broad power is subject to traditional privileges.

File Protective Claims If Necessary

Keep in mind that sometimes resolutions of estate tax issues may impact income tax issues related to the partnership or the estate. Be sure to analyze whether the resolution of the estate tax issue might come too late to file a claim for refund on the income tax side. If so, you may find it necessary to file protective claims for refund to protect rights to income tax refunds that may eventually be due.

Consider Whether it is Feasible to Keep Partnership in Place

At least until the examination of the transfer tax return has been closed and the taxpayer's tax liability finally determined, it is better if the partnership remains in place. As discussed earlier, although facts that occur after the valuation date are arguably irrelevant, the IRS does not hesitate to use those facts when doing so might result in the increase in value of the transferred interest (and resulting transfer tax); and terminating the partnership could play into the IRS's hands in this regard.

Treat Informal Interviews as Depositions

Although interviews by the IRS can be quite informal, neither the taxpayer nor his advisors should be caught off guard. These interviews are, in essence, depositions. In order to ensure that any additional requests for documents and information are provided in writing, such interviews likely ought to be held at an advisor’s office (that of the attorney or accountant), rather than at the taxpayer’s office or home. Consider also having a court reporter present to ensure that the taxpayer’s responses are not misconstrued.

Although this article refers to limited partnerships, many of the suggestions contained herein also apply to other closely held entities, such as limited liability companies.

Keep in mind, however, that relief of the contributing partner’s debt in this regard may require consideration of income tax issues for that partner.

Qualified Severances for GST Tax Purposes

Final & Proposed Regulations issued August 2, 2007

By Julie K. Kwon

Under the law prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the only severances recognized for GST purposes were those dividing single trusts already treated as separate trusts under Section 2654(b), based on the different beneficiaries' separate and independent shares or its multiple transferors. Thus, if a single trust was severed into separate trusts recognized under applicable state law to resolve disputes among interested parties, the severance was not recognized for GST tax purposes and parties would remain yoked together for GST tax purposes. In addition, even if the severance of a single trust with an inclusion ratio between zero and one was recognized, it resulted in separate trusts with the same inclusion ratio as the original single trust.

EGTRRA introduced Section 2642(a)(3), which describes "qualified severances" that will result in trusts that will be treated as separate trusts thereafter for GST purposes. In addition, certain severances of trusts with inclusion ratios between zero and one will result in separate trusts with inclusion ratios of zero and one. Section 2642(a)(3) applies to severances occurring after December 31, 2000. Section 2642(a)(3) also states that the trusts resulting from a qualified severance will be treated as separate trusts "thereafter" for GST tax purposes, indicating that the qualified severance becomes effective at the time when it occurs.

On August 2, 2007, the Treasury Department issued both Final Regulations (T.D. 9348) and Proposed Regulations (Notice of Proposed Rulemaking REG-128843-05, 72 Fed. Reg. 48249 (August 2, 2007)) relating to qualified severances, to be effective from August 2, 2007.

Definition of Qualified Severance.

Regulation §26.2642-6(b) itemizes the requirements for a qualified severance:

The severance of a single trust (other than a division described in Regulation §26.2654-1(b) which addresses divisions of trusts included in the transferor's gross estate) pursuant to the governing instrument or applicable local law.

The severance is effective under local law. Section 2642(a)(3) states that "any means available under" local law or the trust instrument will be effective. Accordingly, even in the absence of the specific power to sever in the trust instrument or state statute, a severance by judicial order or other means available under local law should suffice for purposes of Section 2642(a)(3).

The date of severance is either the date selected by the trustee as of which the trust assets are to be valued to fund the resulting trusts, or the court-imposed date of funding where the local court with jurisdiction over the trust has ordered the trustee to fund the resulting trusts on or as of a specific date. However, a date will only qualify under the regulation if funding must commence immediately, and funding must occur within a reasonable time (but in no event more than 90 days) after, that selected valuation date. This provision acknowledges the practical impossibility of valuing all of the trust assets, making allocation decisions and completing the actions necessary to transfer assets to fund a non-pro rata division on the same day. However, the regulation does not require notice to the Internal Revenue Service or otherwise detail how the trustee will evidence the selection of the valuation date. Example 11 under the Final Regulations illustrates the operation of this funding provision.

The single trust (original trust) is severed on a fractional basis, such that each new trust (resulting trust) is funded with a fraction or percentage of the original trust, and the sum of those fractions or percentages is one or 100 percent, respectively. The regulation expressly authorizes the use of a formula to determine this fraction or percentage and the non-pro rata division of assets among the resulting trusts based on the fair market value of the assets on the date of severance. However, if funding on a non-pro rata basis, “each resulting trust must be funded by applying the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of severance.” Example 5 under the Final Regulations illustrates the method of funding the resulting trusts that conforms to these Final Regulations as required for a qualified severance. The severance of a trust based on a pecuniary amount will not constitute a qualified severance.

The terms of the resulting trusts must provide, in the aggregate, for the “same succession of interests” of beneficiaries as are provided in the original trust. This requirement is satisfied if the beneficiaries of, and their respective beneficial interests in, the original trust remain the same after the severance in the resulting separate trusts when those resulting trusts are viewed collectively.

Thus, the terms of the trusts resulting from a qualified severance are not required to be identical, as long as the trusts collectively preserve the beneficial interests under the original single trust. However, state statutes, to the extent they address trust severances at all, typically require that resulting trusts remain governed by terms “identical” to those terms governing the original, single trust. Thus, a judicial reformation may be required to sever a trust on terms that differ from the original trust if the applicable local law and trust instrument lack express authorization for divisions resulting in trusts with different terms.

Most rulings to date applying Section 2642(a)(3), prior to the issuance of the recent Final Regulations, involve qualified severances resulting in separate trusts with terms identical to the original trust, in most cases because the taxpayers severed pursuant to a state statute or governing instrument authorizing severances on identical terms. Thus, most rulings involving qualified severances have not addressed how trusts may differ from the original trust without changing the succession of beneficial interests under the original single trust for purposes of Section 2642(a)(3). However, the Examples under new Regulation §26.2642-6(j) provide additional guidance in this respect.

Example 1 under the new qualified severance regulation parallels Example 1 under Regulation §26.2654-1(b)(1), as the latter similarly requires preservation of the same succession of beneficial interests after severance of a trust included in the transferor’s estate or created under the transferor’s will. Thus, the preamble to the regulations under Section 2654 may provide helpful guidance that similarly applies to interpretation of this requirement for qualified severances:

The Final Regulations provide that the trusts resulting from the severance of a single testamentary trust need not be identical. Thus, if the trust provides income to spouse, remainder to child and grandchild, the trust may be severed to create 2 trusts, 1 with income to spouse, remainder to child and a second with income to spouse remainder to grandchild. This result could be achieved through proper estate planning in any event. However, the regulations make it clear that the resulting trust must provide for the same succession of interests as provided for under the original trusts. Thus, a trust providing for an income interest to a child, with remainder to a grandchild, could not be divided into 1 trust for the child (equal in value to the child's income interest) and another for the grandchild.

As indicated in the preamble to Regulation §26.2654-1, Example 3 under Regulation §26.2642-6(j) precludes the "horizontal" division of trusts based on the actuarial value of the respective beneficiaries' temporal interests. The Final Regulations regarding qualified severances also provide several additional examples to illustrate the extent to which trusts may differ from the original trust without changing the succession of beneficial interests under the original single trust for purposes of Section 2642(a)(3).

The Final Regulations describe in particular certain severances of wholly discretionary trusts from which distributions may be made to any one or more beneficiaries on a non-pro rata basis that will satisfy this "same succession of beneficial interest" requirement if:

(i) The terms of each resulting trust are the same as the terms of the original trust, though each permissible beneficiary of the original trust is not a beneficiary of all of the resulting trusts;

(ii) Each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if none, "on a per-capita basis;"

(iii) The severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under Section 2651) than the person or persons who held the beneficial interest in the original trust; and

(iv) The severance does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust.

The regulation provides an example of a severance of a wholly discretionary trust that maintains the "same succession of beneficial interests." A discretionary trust for the benefit of A, B, and C and their descendants with the remainder to be divided equally among those three families is severed into three separate trusts of equal value: one for the benefit A and A's descendants, one for the benefit of B and B's descendants, and one trust for the benefit of C and C's descendants. This example for severances of discretionary trusts parallels Example 5 under Regulation §26.2601-1(b)(4)(E) addressing permissible modifications of trusts grandfathered from application of the GST tax that will not subject the trusts to such tax.

This provision authorizing certain severances of discretionary trusts facilitates divisions of trusts along family lines, which are often important means of resolving family disputes. However, several aspects of this rule require additional clarification. Under the example, the meaning of "per capita" for purposes of this rule is unclear. If A, B and C described in the example are the transferor's children, then a per capita division treats each family line equally and likely reflects the intention of most transferors or interested parties. However, if A is the transferor's child while B and C represent the transferor's grandchildren born to a deceased child who was A's sibling, then the example results in the allocation to A's trust of only one-half the amount of property allocated to the trusts held for members in A's sibling's family. The division of property "per capita" may significantly differ among separate family lines based on the chance order of deaths of family members and the number of children each individual chooses to have. In contrast, experience suggests that transferors and parties negotiating resolutions to disputes regarding the division of trust property typically prefer a "per stirpes" division of property that preserves the shares of property allocated to each family line, beginning with a per capita division at the children's generation. If such per stirpes division was actually contemplated in this provision, then a technical correction might revise the reference to clarify that a per stirpes measure of the beneficiaries' interests after the severance is appropriate.

The Final Regulations also do not express whether a severance along family lines must preserve current or remainder interests in all resulting trusts so that the members of each family line may resort to the other trusts upon exhaustion of the trust originally held for that family's benefit. This example within Regulation §2642-6(d)(5)(ii) does not appear to require that each of A, B and C and their respective descendants maintain interests in all of the trusts resulting from the severance to the extent that any single trust is exhausted. However, Examples 2 and 7 of the Final Regulations illustrating qualified severances recite facts showing that the beneficiaries retain their interests in the remainders of both trusts resulting from the severance in the event a single trust is exhausted. However, without specific discussion, the Final Regulations remain unclear as to whether the preservation of the original beneficiaries' interests in all of the post-severance trusts is required for a qualified severance.

In addition, the Final Regulations do not provide extensive guidance regarding the standards for the exercise of discretion that would meet the definition of a discretionary trust for purposes of this exception. Example 2 addressing this exception merely states that the trustee may distribute "as the trustee deems advisable." Hopefully, this absolute discretion without qualification is not the only type that satisfies this exception and other discretionary standards considered similarly non-ascertainable for transfer tax purposes (i.e., "best interests and welfare," "comfort" or "happiness") will suffice.

In the case of a qualified severance of a trust with an inclusion ratio as defined in section 26.2642-1 of either one or 0, each trust resulting from the severance will have an inclusion ratio equal to the inclusion ratio of the original trust.

A trust with an inclusion ratio between zero and one must be severed initially into two trusts. One resulting trust must receive that fractional share of the total value of the original trust as of the date of severance equal to the applicable fraction and will have an inclusion ratio of zero. The other resulting trust must receive the remaining fractional share of the original trust and will have an inclusion ratio of one. However, if the applicable fraction of the original trust is .50, the trustee may designate which of the resulting equal trusts will have an inclusion ratio of zero and of one. The regulation confirms that each resulting trust may be further divided in additional qualified severances to create further separate trusts.

Qualified Severances of "Grandfathered" Exempt Trusts.

Section 2642(a)(3) addresses the recognition of the creation of separate trusts resulting from a qualified severance for GST tax purposes. However, the GST tax rules, including those authorizing qualified severances, do not apply at all to an "exempt trust" that is grandfathered from the imposition of GST tax. Instead, Regulation §26.2601-1(b)(4) (discussed further below in Section V.B of this outline) describes rules for determining whether a modification, judicial construction, settlement agreement, or trustee action with respect to an exempt trust will cause it to lose its exempt status. Thus, a severance of an exempt trust must satisfy those rules to avoid becoming subject to GST tax.

However, where contributions are added to a grandfathered trust after September 25, 1985, Regulation §26.2601-1(b)(1)(iv)(A) deems the trust to consist of one separate share attributable to contributions before such date that is not subject to GST tax (the "non-chapter 13 portion") and another separate share attributable to contributions after such date that is subject to GST tax (the "chapter 13 portion"). Regulation §26.2642-6(g) confirms that any such trust may be severed into two trusts in accordance with Regulation §26.2654-1(a)(3) to segregate the non-chapter 13 portion from the chapter 13 portion, and that the trust holding the chapter 13 portion may be further divided by qualified severance.

Reporting requirements.

Regulation §26.2642-6(e) details the information necessary to report a qualified severance to the IRS. The regulation does not require that a qualified severance be reported to be effective for GST purposes, though reporting is advisable to avoid future confusion when reporting subsequent GST events.

A qualified severance is reported by filing Form 706-GS(T), "Generation-Skipping Transfer Tax Return for Terminations" (or such other form as the IRS may provide for the purpose of reporting qualified severances) by the due date of the gift tax return (including extensions) for gifts made during the year in which the severance occurred, or if no gift tax return is filed, by April 15th of the year immediately following the year during which the severance occurred. Treas. Reg. §2642-6(e), (k)(2). The IRS requests that filers write the words "Qualified Severance" at the top of the return and attach a Notice of Qualified Severance including the basic information regarding the original and resulting trusts and their respective inclusion ratios itemized in the regulation. Treas. Reg. §2642-6(e).

- **Recognition of Capital Gain or Loss.**

Section 1001 governs the determination of the amount and recognition of capital gain or loss for income tax purposes upon the sale or other disposition of property. Effective as of August 2, 2007, Treasury Regulation Section 1.1001-1 is amended to add a helpful new subparagraph (h) describing a safe harbor for income tax purposes for certain severances of trusts, including without limitation qualified severances under Treasury Regulation Section 26.2642-6 or severances described in Treasury Regulation Section 26.2654-1(b). This new provision addresses the concern that the severance of a trust may be deemed to create a taxable exchange resulting in the recognition of capital gain by one or more of the trust beneficiaries.

The IRS addressed taxable gains resulting from the severance of a trust in PLR 9731041. PLR 9731041 describes the proposed partition of a single trust grandfathered from application of the GST tax into two separate trusts to be governed by the terms of the original trust. One resulting trust would own all of the closely held company stock and the other owning all of the remaining trust assets. Certain beneficiaries entitled to annual fixed payments from the single trust also proposed to renounce their interests in the trust holding company stock as the other resulting trust was determined to be actuarially sufficient to provide for their annual payments entirely. Due to the trustee's power to make non-pro rata distributions under the trust instrument and local law, the IRS concluded that the partition was not a taxable event for income tax purposes. However, the IRS relied primarily upon *Cottage Savings Ass'n. v. Comm'r*., in its analysis of whether the partition resulted in recognition of gain or loss under Section 1001.

In *Cottage Savings*, the Court held that a realization event under Section 1001(a) occurs upon an exchange of properties that are "materially different." The Court further stated that properties are "materially different" for purposes of Section 1001(a) to the extent their respective possessors enjoy legal entitlements that are different in kind or extent. Under this standard, the Court concluded that a taxpayer's exchange of interests in groups of mortgage loans considered "substantially identical" by the regulating agency nevertheless resulted in a taxable exchange because the mortgage loans made to different obligors and secured by different homes embodied distinct legal entitlements. In PLR 9731041, the IRS applied the *Cottage Savings* analysis and concluded that the partition of the single trust would not change the beneficiaries' interests. Thus, the IRS concluded that "[I]t is inconsistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the two successor trusts will not differ materially from their interests in the existing trust."

The IRS subsequently has ruled favorably for taxpayers that severances of trusts will not result in a taxable exchange under Section 1001 after applying the *Cottage Savings* test. However, the IRS also has declined to rule on at least one request for a ruling on this issue, based on "the factual nature of the problem or in the interest of sound tax administration" without offering further explanation. Given the IRS's reliance on *Cottage Savings* , taxpayers must analyze whether beneficiaries may obtain interests in the trust after a severance that are "materially different" from their original interests to avoid unexpected recognition of taxable gain under Section 1001. In particular, a severance that results in separate trusts governed by terms that are not identical to the original trust may warrant close scrutiny to ensure that resulting beneficial interests are not "materially different" under the *Cottage Savings* test -- even though the severance may retain the "same succession of interests" for GST tax purposes.

Treasury Regulation Section 1.1001-1(h) incorporates the language of the *Cottage Savings* test and provides that any severance of a trust will not constitute an exchange of property for other property differing materially either in kind or in extent if--

An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and

If the separate trusts created by the severance are funded on a non-pro rata basis (as provided in Treasury Regulation Section 26.2642-6(b)(3)), the non-pro rata funding is authorized by an applicable state statute or the governing instrument.

Treasury Regulation Section 1.1001-1(h)(1) is narrower in scope than the definition of a "qualified severance" under Code Section 2642(a)(3), which includes a severance that occurs pursuant to "any means available under" local law (not only by state statute). Accordingly, even in the absence of the specific power to sever in the trust instrument or state statute, a severance by judicial order or other means available under local law should suffice for purposes of the qualified severance statute. However, Treasury Regulation Section 1.1001-1(h)(1) requires authorization by "state statute" if the trust instrument does not expressly direct or authorize the severance. This express limitation to statutory authority potentially excludes severances that do not fit squarely within any statute but are effective under broader "state law." For example, a court with proper equitable jurisdiction generally has the power to divide a trust by reformation. The basis for distinguishing among alternative means that are equally effective under state law for severance of a trust in the regulation is unclear, especially given the statutory direction to recognize any severance effective under local law.

The Preamble notes that "[n]o inference is to be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in §1.1001-1(h)(1)." Where a severance is not described in the new safe harbor, the severance must be reviewed for the two elements of a taxable event for income tax purposes under Treasury Regulation Section 1.1001-1: whether an exchange of property has occurred, and if so, whether the exchange was "for other property differing materially either in kind or in extent." No exchange should result from a severance pursuant to the trustee's authority, because the trustee's ongoing power generally prevented the beneficiaries from acquiring a fixed and identifiable interest in the trust that would be altered by the severance. The trustee's exercise of a severance power should be treated the same as any other exercise of a trustee's discretion, such as the discretion to make distributions. For example, a severance of a trust providing for wholly discretionary spray distributions of income and principal to beneficiaries does not create interests differing from the beneficiaries' interests in the original trust because those were always subject to change through the exercise of the trustee's discretion. Thus, the beneficiaries do not receive any new interest different from the original interest to which they were entitled and the severance should not incur gain or loss for income tax purposes. However, a severance that results from any means other than pursuant to the trustee's authority must be reviewed for an exchange of property differing materially in kind or in extent.

Proposed Regulations.

Simultaneous with the issuance of the Final Regulations regarding qualified severances, the Treasury Department issued Proposed Regulations addressing issues that it considered as requiring further consideration. Notice of Proposed Rulemaking REG-128843-05.

The most significant change under the Proposed Regulations is the recognition of all severances effective under state law for GST tax purposes. Proposed Regulation § 26.2642-6(h) clarifies that separate trusts created in a non-qualified severance (other than a severance described in Regulation §26.2654-1) that are treated as separate under applicable state law will be respected as separate after the date of the severance for all GST tax purposes. However, the inclusion ratio of the resulting trusts will be the same as the inclusion ratio of the original trust immediately before the severance. Thus, the non-qualified severance of a trust with an inclusion ratio between zero and one will not produce separate trusts with the most efficient inclusion ratios of zero and one. However, the proposed regulation confirms that the post-severance recognition of the separate resulting trusts means that the allocation of GST exemption, making of various GST tax elections and occurrence of generation-skipping transfers from one of such trusts will not impact any other such trust for GST tax purposes. Such recognition of non-qualified severances would increase the alternatives for taxpayers to remedy or improve the configuration of trusts creating adverse GST tax consequences. If Treasury ultimately adopts the position recognizing the separate trusts resulting from non-qualified severances , compliance with the requirements for a “qualified severance” will be unnecessary in cases where a change in the inclusion ratio from the original trust is unnecessary.

Proposed Regulation §26.2642-6(d)(4) introduces a new rule providing that if a severance is funded on a non-pro rata basis, each asset is valued solely for funding purposes by multiplying the fair market value of the asset held in the original trust as of the date of severance by the fractional or percentage interest in that asset being distributed to that resulting trust. “Thus, the assets must be valued without taking into account any discount or premium arising from the severance, for example, any valuation discounts that might arise because the resulting trust receives less than the entire interest held by the original trust.” *Id.* However, it is unclear that any basis for this addition exists in the language of Section 2642(a)(3) or its legislative history. Moreover, this regulation will be internally inconsistent to the extent it requires funding at fair market value but denies legitimate discounts or premiums in the valuation of trust assets pursuant to applicable state law. The trustee also may breach its fiduciary duty by complying with this proposed regulation, to the extent compliance results in an allocation different from the allocation that would result from funding based on the fair market values determined under state law.

Proposed Regulation §26.2642-6(d)(7)(ii) also clarifies that a qualified severance of a trust with an inclusion ratio between zero and one may create multiple trusts. Section 2642(a)(3) states that a trust with an inclusion ratio between zero and one must be severed into two trusts, indicating that the statute did not contemplate a severance resulting in multiple trusts and requiring a series of severances to create multiple trusts. However, Section 2642(a)(3)(B)(iii) gives the Treasury the ability to broaden the definition of a qualified severance by providing that “[t]he term ‘qualified severance’ includes any other severance permitted under regulations prescribed by the Secretary.” Under this delegation of authority, the Proposed Regulation provides that a qualified severance of a trust with an inclusion ratio between zero and one may create more than two resulting trusts if one or more resulting trusts in the aggregate receive that fractional share of the value of the original trust as of the date of severance equal to the applicable fraction of the original trust. The trust or trusts receiving such share will have an inclusion ratio of 0, and each of the other resulting trust or trusts will have an inclusion ratio of one. If two or more of the resulting trusts receives a fractional share of the value of the original trust equal to the applicable fraction, the trustee may designate which of those resulting trusts will have an inclusion ratio of 0 or of one.

Julie K. Kwon is a partner in the law firm of McDermott Will & Emery LLP based in the Firm’s Chicago office. As a member of the Private Client Department, she advises clients on a variety of matters, including estate, gift and generation skipping transfer tax issues, trust and estate administration, contested trust and tax matters, and construction and reformation of wills and trusts.

She chairs the Estate & Gift Tax Committee of the Section

P.L. 107-16, 107 th Cong., 1 st Sess. (June 7, 2001).

See Treas. reg. §26.2654-1(a)(3), including Example 8.

Transfers from a trust with an inclusion ratio of 0 are not subject to GST tax, whereas transfers from a trust with an inclusion ratio of one are fully subject to GST tax.

Section 2642(a)(3) permits the issuance of regulations describing severances in addition to those described in the statute that will be treated as "qualified severances."

In contrast, Regulation §26.2654-1(b)(1) recognize some severances of trusts included in a transferor's taxable gross estate as "retroactive" to the date of death, even if the severance is not complete at the time of death or the due date of the federal estate tax return.

*See*PLRs 200713002, 200713001, 200502036, 200451021, 200441022, 200429004, 200408014, 200403072, 200519008, 200508001, 200502036, 200451029, 200451021, 200441022, 200352011, 200351010, 200340015, 200223016, 200213014. In numerous instances, a trust for which the qualified terminable interest property ("QTIP") election under Section 2056(b)(7) was made is severed on identical terms because the severance is required solely to facilitate an effective reverse QTIP election under Section 2652(a)(3). *See*200540007, 200519008, 200508001, 200451029, 200443025, 200441022.

Example 1 of Regulation §26.2642-6(j) addressing qualified severances parallels the following Example 1 of Regulation §26.2654-1(b)(1), in each case illustrating a trust severance that preserves the succession of beneficial interests in the original trust:

Example 1. Severance of single trust. T's will establishes a testamentary trust providing that income is to be paid to T's spouse for life. At the spouse's death, one-half of the corpus is to be paid to T's child, C, or C's estate (if C fails to survive the spouse) and one-half of the corpus is to be paid to T's grandchild, GC, or GC's estate (if GC fails to survive the spouse). If the requirements of paragraph [Regulation §26.2654-1](b) of this Section are otherwise satisfied, T's executor may divide the testamentary trust equally into two separate trusts, one trust providing an income interest to spouse for life with remainder to C, and the other trust with an income interest to spouse for life with remainder to GC. Furthermore, if the requirements of paragraph [Regulation §26.2654-1](b) of this Section are satisfied, the executor or trustee may further divide the trust for the benefit of GC. GST exemption may be allocated to any of the divided trusts.

Regulation §26.2601-1(b)(4) defines "exempt trust" as a trust that is not subject to GST tax due to the application of Regulation §26.2601-1(b)(1) to (3).

The notice should identify: the severed trust, the name of the transferor, date of creation, tax identification number, the inclusion ratio of the trust before severance, each of the trusts resulting from the severance, the date of the severance, the fraction of the total assets of the original trust funding each resulting trust and other details explaining the basis for funding the resulting trusts, the inclusion ratio of each resulting trust.

499 U.S. 554 (1991).

Id. at 560-61.

Id. at 564-65.

PLR 200010037 (trustee had discretionary power to divide trust and IRS concluded trustee's division of trust was not an exchange and no gain realization). Similarly, in PLRs 200116016 and 200210056 trustee's power in trust instrument to divide trusts and the subsequent division of trust was not an exchange and no gain realization. In PLR 200128035, the IRS determined the beneficiaries interests in proposed trusts resulting from a division of a trust were not materially different from their interests in the original trust, and, therefore, no gain realization.

PLR 9831023.

For a detailed discussion of *Cottage Savings* and its application to planning with trusts for GST tax purposes, *see* Lloyd Leva Plaine, "How Cottage Savings and Recognition of Gain Relate to Trusts," 38th Annual Heckerling Institute on Estate Planning, Chapter 4 (2004).

§2642(a)(3).

The Proposed Regulations continue to deny the recognition of separate *shares* of a single trust that are not actually severed into separate trusts. See Proposed Regulation 26.2654-1(a)(1)(i). However, the rationale for treating separate shares differently from separate trusts for GST tax purposes is unclear and consistent treatment for both separate types of interests would seem appropriate.

Executives and Others Face Tough Tax Liability Unless Deferred Compensation Deals Timely Updated For New Internal Revenue Code Section 409A Compliance

By Cynthia Marcotte Stamer

American businesses and their employees and other service providers frequently participate in employment or settlement agreements, incentive compensation, deferred compensation plans or other deferred compensation arrangements that defer payment of compensation for services performed in one taxable year until a later year. Parties sponsoring or entitled to receive compensation under these deferred compensation plan need to act promptly to evaluate the implications of new Internal Revenue Code ("Code") § 409A upon such arrangements to avoid unintentionally triggering harsh tax consequences for employee or service provider entitled to receive the compensation.

On October 22, 2007, the Internal Revenue Service ("IRS") granted employers additional time to finish updating "deferred compensation plans" covered by Code § 409A to comply with the broad reaching provisions of § 409A. While providing welcome breathing room, most businesses and employees involved in deferred compensation arrangements covered by Code § 409A still will need to act expeditiously to ensure that necessary arrangements to update their particular deferred compensation arrangements are timely completed.

Enacted to curb perceived abuses related deferred pay and other compensation arrangements for high-ranking executives, Section 409A essentially regulates any arrangement that defers compensation other than those specifically exempt from its provisions. Code § 409A defines "deferred compensation plan" broadly to reach to a wide range of practices and arrangements. Because of the broad definition of “deferred compensation plan” employed by Code 409A, it impacts virtually all types of pay and compensation practices that operate to defer the payment of compensation beyond the tax year of the taxable year of the performance of services giving raise to the compensation right. As defined by Code § 409A an arrangement generally provides for the deferral of compensation if, under the terms of the plan or other arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. Accordingly, Section 409A impacts deferred compensation and pay arrangements established pursuant to formal deferred compensation plans, as well as those created by employment agreements, severance agreements, settlement agreements, certain bonus agreements, change of control and other corporate transactions, and a host of other contexts.

Until October 22, 2007, businesses and employees faced a December 31, 2007 deadline to update deferred compensation plans to comply with Code § 409A. In Notice 2007-86, however, the IRS granted additional time for employers to finish updating deferred compensation plans subject to Code § 409A to comply with from December 31, 2007 to December 31, 2008, provided that the arrangements are operated in good faith operational compliance with final regulations published earlier this year for the period from January 1 to December 31, 2008.

Added to the Code by Section 885 of the American Jobs Creation Act of 2004 (the "Act") and applicable to virtually all nonqualified deferred compensation practices, plans and arrangements, Code § 409A will impose punitive tax consequences upon employees and other service providers entitled to receive deferred compensation under a deferred compensation plan or other covered deferral arrangement unless the arrangement either meets the requirements of § 409A or otherwise qualifies as exempt from its provisions. If a deferred compensation arrangement does not comply with Code § 409A or otherwise qualify as exempt from its provisions, the employee or other service provider earning the compensation immediately incur the following liability to the IRS:

- Income tax on all amounts deferred under the arrangements regardless of whether the taxpayer is entitled to payment of that compensation at that time;
- A 20% penalty tax; and
- Interest is assessed at a "nonpayer rate" (which is higher than that imposed for other violations) plus 1% from the date or dates of deferral.

This liability will arise in the year that the employee obtains a right to receive the compensation that is not subject to a substantial risk of forfeiture regardless of whether the employee in fact then has a right to receive the compensation or whether the arrangement otherwise meets applicable requirements to qualify for deferred taxation under other relevant provisions of the Code.

Furthermore, if the employer seeks to protect an affected employee from the taxes and penalty by making tax protection payments to cover the tax liability triggered by Code § 409A, Code § 409A will bar the employer from deducting the tax protection payments and impose additional excise tax liability equal to 20% of the amount of any such tax-protection payment on the recipient employee or other service provider.

Final regulations construing Code § 409A exempt various compensation arrangements from its provisions. Employers planning to treat one or more compensation arrangements as exempt from the Section 409A mandates beware, however. While the IRS granted additional time for employers to bring covered deferred compensation arrangements into compliance with § 409A, the guidance does not grant additional time to redesign existing programs to qualify as exempt from § 409A. Therefore, employers desiring to treat any deferred compensation arrangements as exempt from Section 409A should act quickly to ensure that that those compensation arrangements intended to qualify as exempt meet all of the conditions for exemption by December 31, 2007.

Some of the more notable highlights of Notice 2007-86 include the following:

- Employers have until December 31, 2008 to amend plans and arrangements to comply with § 409A and the final regulations, including the specification of the time and form of payment;
- Nonqualified deferred compensation arrangements subject to § 409A must operationally comply with § 409A on a reasonable, good faith basis based on the statute and any generally applicable guidance issued through December 31, 2008;
- Until January 1, 2008, the IRS will not require compliance with either the QACA Rule issued in October 2005 or the final regulations but will treat

compliance with either guidance as reasonable, good faith compliance; After January 1, 2008, however, reliance on the QACA Rule will no longer be permitted;

- The reasonable, good faith standard will be treated as violated if the employer exercises discretion under a plan in a manner that causes the plan to fail to meet the requirements of § 409A;
- Plans may permit changes to existing elections as to the form and time of payments through December 31, 2008 provided that such changes made in 2008 can’t apply to amounts that would otherwise be payable in 2008 or cause an amount to be paid in 2008 that would otherwise not be payable in 2008;
- Payment elections under a nonqualified deferred compensation plan may still be linked to elections under a qualified retirement plans, a § 403(b) annuities, § 457(b) eligible plans or certain foreign broad-based retirement plans through December 31, 2008;
- The Notice extends the relief set forth in Notice 2005-1 and the preamble of the QACA Rule that permitted the substitution of nondiscounted stock options or SARs for discounted stock options or SARs to allow before December 31, 2008 the replacement of a stock option or SAR that otherwise provides for a deferral of compensation under § 409A with a stock option or SAR that satisfies the criteria for exemption from the application of § 409A subject to fulfillment of certain specific conditions; and
- The Notice affirms the IRS plans to establish a program for correcting certain § 409A errors in the near future.

Accordingly, to avoid triggering unintentionally the punitive tax penalties of § 409A, employers should continue to move expeditiously to identify all arrangements potentially impacted by Code § 409A and to act to redesign and redeploy those arrangements either to comply with Code § 409A, to qualify for exemption from its provision, or to otherwise to assess and report tax as required to comply with Code § 409A. To this end, employers and employees or other service providers involved in these arrangements that have not already done so should take prompt action to:

- Inventory all compensation and pay arrangements to identify those that may provide "deferred compensation;"
- Identify those arrangement subject to the Section 409A rules and those that may qualify as exempt under the final regulations;
- Assess the extent to which each applicable deferred compensation arrangement in form and operation complies with the requirements of § 409 or, where applicable, the conditions for exemption;
- Act promptly to implement any corrections necessary to preserve any desired ability to treat a deferred compensation arrangement as exempt from Code § 409A before December 31, 2007, pending further guidance;
- Administer all covered deferred compensation arrangements to comply with Code § 409A after December 31, 2007;
- Timely amend all covered deferred compensation arrangements to comply with Code § 409A by December 31, 2008; and

- Operate all programs potentially covered by Code § 409A in operational compliance with the final regulations published earlier this year.

IRS and Department Of Labor Issue Automatic Enrollment and Investment Guidance

By Cynthia Marcotte Stamer

Recent guidance from the U.S. Department of Labor ("Labor Department") and Internal Revenue Service ("IRS") is helping to chart a pathway for plan sponsors and fiduciaries of 401(k), 403(b) and 457 defined contribution plans to add and use automatic enrollment and investment features automatically to enroll and invest contributions of participants that fail to return plan enrollment and investment elections. Using automatic or default enrollment and investment features can help employers increase participation in their 401(k) or other defined contribution plans. Until recently, however, concern about tax disqualification and fiduciary liability risks deterred most employers and plan fiduciaries from using these processes to promote plan participation.

As part of the Pension Protection Act (PPA,[i] however, Congress sought to facilitate the adoption by employers of automatic enrollment features in 401(k), 403(b), and 457 plans by enacting a series of amendments to the Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code (the "Code"). Under the PPA, Congress amended the Code to make it easier for employers to sponsor 401(k), 403(b) and 457(b) defined-contribution plans containing default enrollment and contribution features without disqualifying the plan. The PPA amendments to the Code establish rules under which these plans can provide that an employee will be automatically enrolled in the plan unless he affirmatively elects not to participate, and permit these plans to avoid some of the

Code's nondiscrimination testing requirements by qualifying for a "safe harbor" by adopting specific plan design features   In addition, the PPA also amended ERISA to provide a safe harbor within which accounts of participants in ERISA-covered 401(k) and other individual account retirement plans who fail to make investment elections can be default invested under the plan and still qualify as "self-directed" investments for purposes of ERISA § 404(c).

On November 8, 2007, the IRS published proposed rules (the "QACA Rule") construing the PPA auto-enrollment amendments to the Code for post December 31, 2007 plan years. The preamble to the proposed QACA Rule provides that employers and plans may rely upon the QACA Rule for purposes of designing and administering default enrollment processes until the IRS adopts final rules. Additionally, on October 24, 2007, the Labor Department published final regulations (the "QDIA Rule") interpreting the statutory relief for plan fiduciaries of 401(k) and other individual account plans covered by ERISA who invest the assets of participants who do not provide investment direction (such as automatically enrolled workers) in "qualified default investment alternatives" or "QDIAs."

Code Requirements For Automatic Enrollment Features

The PPA amends the Code to facilitate employer adoption of automatic enrollment in 401(k) plans, and similar features in 403(b) tax-sheltered annuities and 457(b) governmental deferred compensation plans. If the requirements of the QACA Rule are met for plan years beginning on or after January 1, 2008, a plan qualifying as a QACA will be deemed to satisfy the actual deferral percentage (“ADP”) and actual contribution percentage (“ACP”) nondiscrimination tests, as well as the top-heavy rules that generally prohibit owners and other key employees from disproportionately benefiting under the plan. In addition, the PPA allows “eligible automatic contribution arrangements” (“EACAs”) to adopt a permissible withdrawal provision to allow plans to return default elective deferrals to participants under certain circumstances without the distributions being subject to the 10% early withdrawal tax that normally would apply.

To qualify as an EACA, the PPA generally requires that the default enrollment arrangement must:

- Allow the participant to elect to have the employer make contributions to the plan on his behalf when a participant fails to return an election;
- Make certain automatic contributions to the plan by the employer on behalf of the participant equal to a uniform percentage of compensation;
- Satisfy the requirements of ERISA §404(c)(5) with respect to default investments; and
- Provide specific information in a notice to participants.

To fall within the new safe harbor for EACAs established by the QACA Rule, a 401(k), 403(b) or 457(b) plan must satisfy several conditions including requirements that:

- The Plan uniformly must apply a minimum and escalating percentage of automatic elective deferrals for each eligible employee who fails to elect otherwise;

- The Plan must give each participant the opportunity to elect out of the plan or to make elective deferrals at a different level;
- The Plan must provide minimum employer matching or nonelective contributions on behalf of each eligible nonhighly compensated employee;
- The Plan must comply with applicable vesting requirements for employer matching or nonelective contributions;
- The Plan must comply with applicable Code requirements that it restrict distributions; and
- The Plan must comply with the Code's requirements for providing notification to participants about its default enrollment provisions.

The QACA Rule, as proposed, provides clarification about the application of these rules in several respects. The following paragraphs highlight some of the key components of this guidance.

Regarding the application of the uniformity requirement, the QACA Rule clarifies that to qualify as a QACA, a plan must uniformly apply the qualified percentage (i.e., an initial minimum automatic elective deferral of 3% of compensation through the end of the plan year following the year of initial participation, increasing by 1% for each of the next three plan years, not ever to exceed 10% of compensation) to all eligible employees. The QACA rule clarifies that the qualified percentages are minimums and that a QACA can provide for higher percentages not in excess of 10%. Additionally, the QACA Rules states that a QACA will not fail the "uniformity" requirement if the plan:

- Varies the elective deferral percentage based on the number of years an employee has participated in the plan;
- Does not reduce the rate of elective deferral under a participant's prior election that is in effect when the QACA becomes effective;
- Limits the amount of elective deferrals so as not to exceed the limits on compensation, elective deferrals, or benefits and compensation (under Code §§401(a)(17), 402(g), and 415, respectively); or
- Suspends employees from making elective deferrals for six months after they take a hardship distribution.

The QACA Rule also specifies that the a plan can allow current employees who were eligible to participate in the CODA immediately before the QACA's effective date and who have an election in effect on the QACA's effective date to be excluded from the plan-specified deferral percentages.

The QACA Rule construes the PPA's requirement that the plan provide notices "within a reasonable period before each plan year" as met where the plan furnishes a notice to participants at least 30 days and no more than 90 days before the beginning of each plan year that explains the QACA and informs participants of the opportunity to elect out of the program or to change their deferral percentages from the QACA's qualified percentages. In keeping with its announced intention under the QACA Rule, the IRS posted on its website a sample notice for use in providing this notice on November 14, 2007.[ii]

With respect to the permissible withdrawals of automatic contributions, the QACA Rule sets forth guidance on returning default elective deferrals to participants. It clarifies that this PPA provision gives all 401(k), 403(b), and governmental 457(b) plans with EACAs to return under the conditions specified in the QACA Rule amounts requested by a participant within 90 days of the first elective deferrals to the EACA. Returned amounts must be distributed with earnings, if any. These distributions are treated as taxable income in the year distributed but are not subject to the early withdrawal tax. If elective deferrals are withdrawn, employees also forfeit any applicable employer matching contributions associated with the withdrawn amounts.

The QACA Rule also reflects the PPA amendments to §4979, which permit an EACA to distribute excess contributions and excess aggregate contributions to participants within six months (rather than two-and-one-half months) after the close of the plan year in which the contributions were made. This provision, which will affect corrective distributions made in 2009, gives plans a longer period to make corrective distributions to avoid the imposition of the 10% excise tax on the employer. The amounts so distributed need not include income allocable to the period after the end of the plan year (i.e., the "gap period income") but are included in the employee's gross income for the taxable year in which they are distributed.

The QACA Rule also clarifies that:

- A plan sponsor need not offer the permissible withdrawal feature to all employees eligible under the EACA, but also may not condition employees' right to receive a distribution on whether or not they elect future elective deferrals;

- The 90-day window for making the withdrawal election begins on the date the amounts would have been includible in the participant's gross income if the amounts were not contributed, and the effective date of the election cannot be later than the last day of the payroll period that begins after the date of the election;
- The distribution generally is the employee's account balance attributable to the default elective deferrals, adjusted for gains and losses, and may be reduced only for generally applicable fees (i.e., the plan may not charge a different fee for this distribution than it would for other distributions);
- Any employer matching contributions forfeited on account of the distributed amounts must remain in the plan and be treated under the plan terms as any other plan forfeitures (i.e., the amounts may not be returned to the employer); and
- Withdrawn amounts other than designated Roth contributions are includible in the employee's gross income and must be reported on Form 1099-R in the year of distribution but are not subject to the 10% additional early withdrawal tax under §72(t).

Fiduciary Relief For Default Investments Under ERISA

The QDIA Rule defines the conditions under which fiduciaries of defined contributions plans providing for participant self-direction of investments can continue to enjoy the protection of the self-directed investment relief provided by ERISA 404(c) when accounts of participants failing to provide direction to the plan are invested automatically in default investment alternatives established under the plan. The QDIA Rule protection requires that the default investment meet all of the technical requirements of the QDIA Rule and applicable IRS regulations, and those fiduciaries otherwise comply with applicable ERISA fiduciary standards when selecting and overseeing the QDIA options.

To meet the requirements of the QDIA Rule, the QDIA Rule specifically requires that default investments meet the following conditions in order for the default investment to be treated as a self-directed investment for purposes of ERISA § 404(c):

• The Plan must offer a “broad range of investment alternatives” as defined in the ERISA § 404(c) regulations;

• The Plan can only make default investments in “qualified default investment alternatives” or “QDIA as defined in the QDIA Rule;

• Default investments are allowed only for participants and beneficiaries given an opportunity to provide investment direction who failed to make an investment choice;

• The Plan must furnish a notice to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter that provides the information dictated by the QDIA Rule;

• The Plan must furnish material, such as investment prospectuses, for the QDIA to participants and beneficiaries;

• The Plan must give participants and beneficiaries the opportunity to direct investments out of a QDIA as frequently as from other plan investments, and not less frequently than quarterly;

- The Plan must limit fees for participants opting out of participation in the plan or electing to self-direct their investments;
- Fiduciaries remain responsible for appropriate selection and monitoring of the QDIA investments in accordance with ERISA's fiduciary responsibility standards; and
- Each QDIA must be managed either by an investment manager, plan trustee, or plan sponsor who is a named fiduciary, or by an investment company registered under the Investment Company Act of 1940.

The QDIA Rule describes four types of mechanisms that can qualify for treatment as a QDIA:

- A product with a mix of investments that takes into account the individual's age or retirement date such as a life-cycle or targeted-retirement-date fund;
- An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date such as a professionally-managed account;
- A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual such as a balanced fund; and
- A capital preservation product for only the first 120 days of participation offered as an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax.

The QDIA Rule does not provide any relief for any default investment of participant contributions in employer securities. Furthermore, in recognition that certain plan sponsors adopted stable value products as their default investment prior to passage of the PPA, the QDIA Rule provides a transition rule that "grandfathers" these arrangements by providing relief for contributions invested in stable value products prior to the effective date of the final QDIA Rule. Otherwise, however, the transition rule does not provide safe harbor relief for future contributions to stable value products. The QDIA Rule also clarifies that a QDIA may be offered through variable annuity contracts or other pooled investment funds.

Other DOL Enforcement & Regulatory Activity

In addition to its publication of the QDIA Rule, the EBSA also published other notable guidance and engaged in aggressive enforcement of ERISA during the first quarter of 2007. During the first three quarters of 2007, for instance, the EBSA:

- Amended Interpretive Bulletin 95-1 to limit its application to the selection of annuity providers for defined benefit plans;
- Revised its rules for imposing civil penalties under ERISA § 502(c)(7);
- Published new rules on the timing and order of issuance of domestic relations orders;
- Released new Mental Health Parity Regulations applicable to health plans;
- Amended safe harbor rules for distributions from terminated individual account plans and termination of abandoned individual account plans to require inherited individual retirement plans for missing nonspouse beneficiaries; and

- Issued a statutory prohibited transaction exemption for cross-trading of securities.

It also has proposed, but not yet adopted in final form, rules concerning when multi-employer pension plan information must made available on request; guidance concerning the selection of annuity providers for individual account plans; additional amendments affecting the assessment and collection of civil penalties under ERISA § 502(c)(7); and guidance about fee and expense disclosures to participants in individual account plans. Meanwhile, EBSA also has maintained an active enforcement agenda.

The Labor Department enforcement activities this year also reflect its 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.

The EBSA continues to investigate embezzlement, kickbacks, and false statements, or other criminal violations involving ERISA-covered employee benefit plans and to refer its findings for prosecution by the Justice Department. The EBSA and Justice Department have announced a number of criminal prosecutions and settlements as a result of these efforts this year.

With business failures of the rise, the EBSA also continues to devote substantial resources to the enforcement of ERISA's fiduciary responsibility rules against bankrupt and financially distresses plan sponsors and the employees, officers and service providers. Labor Department officials report that these aggressive enforcement activities resulted in the recovery by the Labor Department of more than $1.4 billion related to pension, 401(k), health and other benefits from companies, company executives and others for alleged violations of ERISA in fiscal year 2006 alone. In addition to prosecutions brought by the Labor Department, companies and individuals that exercise discretion and control of the administration or funding of employee benefit plans regulated by ERISA also may be sued personally by participants and beneficiaries for breach of fiduciary under ERISA. 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 continues to aggressively pursue ERISA enforcement regardless of the size of the plan sponsor or its plan, or the business hardships that the plan sponsor may be facing.[iii] 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.

Earlier this year, the EBSA also initiated a nationwide investigation project that examines and seeks to uncover ERISA violations arising from the use by the adviser/consultant of its position with a benefit plan to generate additional fees for itself or its affiliates, failures to adhere to investment guidelines, improper selection or monitoring of the consultant or adviser, potential criminal violations, such as kickbacks or fraud and other potential improprieties under ERISA. The scrutiny of the consultant and advisor activities follows Congressional hearings examining these relationships earlier this year.[iv]

In addition, EBSA also has ongoing national projects targeting health care fraud involving multiple employer welfare arrangements or "MEWAs," violations of ERISA's rules for the timely investment, administration and use of employee contributions; enforcement of ERISA's requirements with respect to various ESOP rules and transactions; investigation of participant and beneficiary complaints; and Form 5500 audit and return enforcement.

Along side these special areas of enforcement, the EBSA also continues aggressively to pursue collection of ERISA civil against plan administrators and others for other violations of ERISA, including:

- Failing to operate the plan prudently and for the exclusive benefit of participants;
- Using plan assets to benefit certain related parties to the plan, including the plan administrator, the plan sponsor, and parties related to these individuals;
- Failing to properly value plan assets at their current fair market value, or to hold plan assets in trust;
- Failing to follow the terms of the plan (unless inconsistent with ERISA);
- Failing to properly select and monitor service providers; and

• Taking any adverse action against an individual for exercising his or her rights under the plan (e.g.;, being fired, fined, or otherwise being discriminated against).

These evolving and ongoing EBSA regulatory and enforcement activities emphasize the continuing and growing need for employee benefit plan fiduciaries, the employers sponsoring these plans, and the internal staff and external consultants involved in the design and administration to act diligently to ensure that their programs are properly designed and administered to comply with ERISA and existing enforcement policy.

---

[i] *Public Law 109-280.*

[ii] *See Sample Automatic Enrollment and Default Investment Notice posted athttp://www.irs.gov/pub/irs-tege/sample_notice.pdf.*

[iii] *See, "Enron Litigation Has Implications For Plan Sponsors And Management," 401K Advisor (December 1, 2006).*

[iv] *See, "Congress Scrutinizing Relationships Between Companies & Executive Compensation Consultants & Other Executive Compensation Practices," H.R. Employee Benefits & Internal Controls E-Update (M ay 25, 2007).*

Agencies Release 2007 Form 5500 Annual Report

By Cynthia Marcotte Stamer

The U.S. Department of Labor Employee Benefits Security Administration ("EBSA"), the Internal Revenue Service ("IRS") and the Pension Benefit Guaranty Corporation ("PBGC") recently released advance informational copies of the 2007 Form 5500 Annual Return/Report of Employee Benefit Plan and related instructions ("Form 5500").

The Form 5500 package released October 10, 2007 includes several changes compared to the 2006 Form 5500 Forms. Significant changes to the 2007 Form 5500 package include:

- A new simplified reporting option for eligible plans with fewer than 25 participants required by the Pension Protection Act ("PPA"); and
- Revised Schedule B instructions to reflect the updated mortality tables and the list of codes used for valuation purposes, as well as for calculating current liability for plan years beginning on or after January 1, 2007.

Instructions included in the package also caution 2008 Form 5500 filers to expect additional changes to the 2008 Form 5500 package in response to changes required to comply with the PPA. Given these expected changes, the EBSA is warning plan administrators expecting to file 2008 short plan year Form 5500s to anticipate that it may be necessary for them to delay preparation of the 2008 short plan year return until the 2008 forms become available for use.

Subject to limited exceptions, all ERISA plan administrators generally are required by ERISA to file an annual Form 5500 for their employee benefit plans.

Separate Form 5500 filing obligations also may apply under the Internal Revenue Code (the “Code”).

All plan administrators and plan sponsors need to keep in mind that timely filing of Form 5500 is important. Plan administrators caught by the EBSA failing to file required Form 5500s can face stiff penalties. For instance, under existing EBSA enforcement policy, plan administrators filing annual reports after the date the report was required to be filed (a “late report”) may be assessed $50 per day, with no limit, for the period they failed to file, determined without regard to any extensions for filing. Plan administrators caught by the EBSA failing to file an annual report may be assessed a penalty of $300 per day, up to $30,000 per year, until a complete annual report is filed. Plan administrators who presently are exposed to these penalties due to an unresolved failure or untimely filing required by ERISA can qualify for reduced penalties by filing these forms in accordance with the EBSA’s existing Delinquent Filer Voluntary Compliance Program (“DFVC Program”). The EBSA recently has released a tool to help plan administrators calculate their penalties under the DFVC Program.

For plans subject to Form 5500 filing obligations under the Code, the Code imposes separate penalties, which are administered and assessed by the IRS. Accordingly, the DFVC program does not resolve any penalties assessable under the Code. Rather, tax penalties for non-filing or late filing in violation of the Code must be resolved separately with the IRS.

If you have questions about the Form 5500 or other ERISA matters relating to the design or administration of your employee benefit plans or human resources practices, contact Cynthia Marcotte Stamer at 972.419.7188 or cMarcotte Stamer@gpm-law.com. cMarcotte Stamer@gpm-law.com.

About Cynthia Marcotte Marcotte Stamer

Vice Chair of Section of Real Property, Probate and Trust Law Employee Benefit Plans And Other Compensation Arrangements Group and Board Certified In Labor and Employment Law by the Texas Board of Legal Specialization, attorney Cynthia Marcotte Stamer has more than 20 years experience helping employers and business leaders, plan fiduciaries and administrators, insurers and other plan vendors and others design, implement, administer and defend health and other employee benefit and compensation, insurance and other human resources practices, policies and strategies.

Proposal to Prohibit Tax Planning Patents - S. 2369

By Rana H. Salti

McDermott Will & Emery LLP

On November 15, 2007, legislation was introduced in the Senate that would prohibit the issuance of any patents for tax planning inventions. The bill, S. 2369, was sponsored by Senate Finance Committee Chairman Max Baucus (D-MT) and Ranking Member Charles Grassley (R-IA), along with Senator Carl Levin (D-MI), Senator Ron Wyden (D-OR), Senator Barack Obama (D-IL), and Senator Jeff Bingaman (D-NM).

S. 2369 would amend Section 101 of Title 35 of the U.S. Code to prevent the grant of patents for any tax planning inventions. “Tax planning inventions” are defined in S. 2369 as “a plan, strategy, technique, scheme, process, or system that is designed to reduce, minimize, avoid, or defer, or has, when implemented, the effect of reducing, minimizing, avoiding, or deferring, a taxpayer’s tax liability or is designed to facilitate compliance with tax laws.” A tax planning invention does not include “tax preparation software and other tools or systems used solely to prepare tax or information returns.”

If successful, the amendments of S. 2369 would apply to any applications for patents or reissue patents that are filed after the date of the enactment of S. 2369. In addition, the amendments would apply to any pending applications for patents or reissue patents.

Senator Baucus noted that “taxpayers should not have to pay a toll charge or worry that they’re violating patent law when they try to file their tax returns. Tax practitioners should be able to provide advice and services to their clients without paying a fee to the patent holder.”

S. 2369 follows the House of Representatives’ efforts to prevent the issuance of tax planning patents. On September 7, 2007, the House passed the Patent Reform Act of 2007 (H.R. 1908) that included a provision making tax planning methods unpatentable. The provision includes a slightly different definition of tax planning method, providing that a tax planning method “does not include the use of tax preparation software or other tools used solely to perform or model mathematical calculations or prepare tax or information returns.”

S. 2369 has been referred to the Senate Judiciary Committee for further review.