The Ultimate Irony: In Light of the Passage of President Obama's Tax Proposal, State Formulaic Construction Statutes May Face Their Own Construction Issues

…And Time For a Construction Proceeding May Be Running Out

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Problems with Distorted Formulaic Dispositions May Continue to Persist

When the federal estate and generation-skipping transfer ("GST") tax regimes lapsed on January 1, 2010, that had a significant trickle-down effect at the state level. When state taxation regimes are entwined with federal tax concepts, what happens when those federal tax concepts disappear?

President Obama's proposal, passed on December 15 by the Senate and December 16 by the House, includes a $5,000,000 estate tax exemption amount and 35% estate tax rate for 2010, with an option to elect out of estate tax treatment and be subject to a carry-over basis regime. Accordingly, the effect of an election to be subject to an estate tax or carry-over basis regime should also be factored into the analysis of formulaic provisions (discussed further below).

A federal estate and GST tax lapse can cause particularly acute problems regarding the construction of formula provisions in dispositive instruments. Many dispositive instruments contain formulaic terminology tied to federal tax concepts, like the federal estate tax exemption amount or GST tax exemption amount. Formula provisions can become distorted if their conceptual underpinnings have been removed from the law.

Before 2010, a disposition in a will of the "federal estate tax exemption amount" or a disposition of the "largest amount that can pass free of federal estate taxes" would have accomplished the same result - a disposition of the largest amount that could pass without the imposition of federal tax. In 2009, that amount would have been $3.5 million.

However, if an estate is not subject to estate tax in 2010, a disposition of the "federal estate tax exemption amount" could be interpreted to mean no disposition at all: if there is no federal estate tax, there can be no federal estate tax exemption amount. On the other hand, a disposition of the "largest amount that can pass free of federal estate taxes" could be interpreted to mean a disposition of the whole estate: if there is no federal estate tax, the whole estate is the largest amount that can pass free of federal taxes.

How ironic that a disposition of the same amount was intended in both scenarios. Yet, depending on terminology used, the whole estate or nothing could be construed to pass - and neither of those results was intended.

States React

To prevent unintended distortion to estate plans, many states introduced legislation in 2010 regarding formulaic dispositions:

Jurisdictions with Bills Pending (As of December 15, 2010)
New Jersey
Ohio

Jurisdictions With Currently Enacted Laws (As of December 15, 2010)
Delaware - 12 Del. C. § 3335 (2010)
District of Columbia - D.C. Code § 20-1108 (2010)
Florida - Fla. Stat. § 736.04114 (2010), Fla. Stat. § 733.1051 (2010)
Georgia - O.C.G.A. § 53-4-75 (2010)
Idaho - Idaho Code § 15-1-501 (2010)
Indiana - Burns Ind. Code Ann. § 29-1-6-1(n)-(r) (2010)
Maryland - Md. ESTATES AND TRUSTS Code Ann. § 11-110 (2010)
Minnesota - Minn. Stat. § 524.2-712 (2010)
Michigan – To be inserted into Chapter 700, Article I of the Michigan Compiled Laws
Nebraska - R.R.S. Neb. § 30-2342.02 (2010)
New York - NY EPTL § 2-1.13 (2010)
North Carolina - N.C. Gen. Stat. § 31-46.1 (2010)
Pennsylvania – To be inserted into Title 20 of the Consolidated Statutes of Pennsylvania
South Carolina – To be inserted into Title 12, Chapter 16 of the South Carolina Code of Laws
South Dakota - S.D. Codified Laws § 10-40A-11, 10-40A-12, 10-40A-13 (2010)
Tennessee - Tenn. Code Ann. § 32-3-113 (2010)

Jurisdictions With Currently Enacted Laws (As of December 15, 2010)
Utah - Utah Code Ann. § 75-3-917 (2010)
Virginia - Va. Code Ann. § 64.1-62.4 (2010)
Washington State – To be inserted into chapter 11.108 of the Revised Code of Washington
Wisconsin - Wis. Stat. § 854.30 (2010)

Most States Provide Statutory Construction Rules

States have generally[1] taken the approach of construing formula clauses during a period of federal estate tax lapse with reference to the law as it existed on December 31, 2009 (when the federal estate tax exemption amount was $3.5 million). Accordingly, in the absence of an applicable federal estate tax in 2010, a disposition of the "federal estate tax exemption amount" or the "largest amount that can pass free of federal estate taxes" would both be interpreted to mean a $3.5 million disposition. These rules of construction apply not only to formulaic dispositions of the federal estate tax exemption amount, but also to formulaic dispositions of the GST tax exemption amount ($3.5 million in 2009).

Judicial Construction Alternative

In Florida and South Carolina, a court is authorized to construe a trust or will that contains a formula disposition in order to determine the decedent's intent. Accordingly, in the absence of a statutory rule of construction, a court proceeding is required.

How Does An Election To Opt Out Of Estate Tax Treatment Effect Statutory Construction Legislation?

Most states provide that their statutory rules of construction will not apply if the federal estate tax or GST tax "becomes applicable" or "becomes effective" before January 1, 2011. Presumably, if an estate is subject to estate tax under the bill that is poised to be signed by the president, the statutory rules of construction will not apply, and formulaic provisions will be keyed to the $5,000,000 exemption amount.

But will the statutory construction rules also fall away if an estate tax/modified carry-over basis election exists and the estate tax option is not chosen? In other words, does the estate tax have to "become applicable" or "become effective" for the particular case at hand, or is it sufficient that the estate tax regime is potentially applicable or effective in 2010 (even though a carry-over basis election is made)?

If the estate tax has to be applicable to the case at hand in order for the statutory construction rules not to apply, there may be an anomalous result if carry-over basis treatment is elected: In the estate tax default treatment scenario, a $5,000,000 exemption would presumably apply in the interpretation of formula clauses. However, if carry-over basis treatment is chosen and the statutory construction rules are applicable, formulaic clauses may be interpreted with a $3,500,000 exemption (because state statutory construction rules typically refer to the law as of December 31, 2009). This election option could present a very difficult dilemma for a fiduciary, typically subject to duties of impartiality, if the fiduciary's election might determine a funding amount.

While formulaic legislation generally seems to have been drafted to anticipate a possible retroactive estate/GST tax, an election about whether to have the estate tax apply does not seem to have been anticipated.

And if State Statutory Construction Rules Do Apply, Do They Always Produce the Best Result?

In many acrimonious situations, if the statutory rules of construction apply, they might prevent an unintended disinheritance. However, query whether those rules of statutory construction always produce the most tax-efficient result.

Take, for example, a will which provides for the largest amount that can pass free of federal estate taxes to fund a trust for the benefit of a surviving spouse and children. If there were no construction rules and that disposition was interpreted in 2010 to mean that the whole estate passed to that trust (a so-called "credit shelter trust"), no federal estate taxes would be due at the death of the surviving spouse. If, however, such a clause was interpreted with reference to the law as of December 31, 2009, the amount passing to the trust would be limited to $3.5 million. If the remainder of the estate passed outright to the surviving spouse, that entire balance would be subject to federal estate tax at the death of the surviving spouse (after 2010).

In a harmonious family situation, it may have been a much more efficient tax result for the entire estate to pass to a trust which would not be subject to federal taxation on the death of the surviving spouse.[2]

Time May be Running Out to Bring a Judicial Proceeding

In all the state formula clause "fix" legislation that has passed so far, there is some provision to enable certain interested parties to bring a judicial proceeding to construe a formula disposition.

Typically, states permit either a general construction proceeding, or a proceeding to determine if a formulaic disposition should be construed without reference to a state's statutory rules of construction.

In Florida, the ability to bring a judicial proceeding is tied to whether a disposition occurred within a defined period. Generally, however, the time frame for commencing a judicial proceeding is within 12 months of death, but can be shorter (in Indiana, for example, the proceeding must be commenced within 9 months of death). Accordingly, if a decedent died early in 2010, time is running out to bring a proceeding (or, in Indiana, may have already run out).

Jurisdictions With Currently Enacted Laws (As of December 15, 2010)	Time for Bringing Judicial Proceeding
Delaware	Within the later of 6 months of (1) death or (2) July 12, 2010 (the effective date of the Delaware legislation) Note, statutory presumption will not apply if a disinterested fiduciary elects to opt out of its application, and no beneficiary objects within 30 days of receipt of written notice of the election
District of Columbia	Within 12 months of death
Florida	Proceeding can be brought if disposition occurred in "applicable period" (Beginning January 1, 2010 until the earlier of (1) December 31, 2010 or (2) the day before the date on which federal estate and GST tax sunset is repealed or modified)
Georgia	Within 1 year of death
Idaho	Within 12 months of death

Jurisdictions With Currently Enacted Laws (As of December 1, 2010)	Time for Bringing Judicial Proceeding
Indiana	Within 9 months of death
Maryland	Within 1 year of death
Michigan	Within the earlier of (a) two years after the decedent's death, or (b) six months after the fiduciary sends notice to the beneficiary
Minnesota	By December 31, 2011
Nebraska	Within 12 months of death
New York	Within 12 months of death
North Carolina	Within 12 months of death
Pennsylvania	Within 12 months of death
South Carolina	Within 12 months of death
South Dakota	Within 12 months of death
Tennessee	Within 12 months of death Note, general rule of construction will not apply if a personal representative elects to opt out of its application with beneficiary consent within 9 months of death
Utah	Within 12 months of death
Virginia	Within 12 months of death
Washington State	Within 12 months of death
Wisconsin	Within 1 year of death

Time Generally Runs From the Commencement of a Proceeding

As practitioners apparently still continue to grapple with uncertainty, the clock is ticking on the ability to bring such a proceeding, which generally must be *commenced* within the applicable time frame.

Accordingly, practitioners may wish to consider at least commencing a proceeding in order to keep their options open.

[1] Florida and South Carolina have taken a different approach (discussed separately). Other states provide for additional exceptions from the statutory construction rules.

[2] Note that state-level taxes may have to be factored into the analysis, and potentially the loss of a spousal basis adjustment for capital gains tax purposes.

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December 1, 2010

The Honorable Max Baucus, Chairman
Senate Committee on Finance
511 Hart Senate Office Building
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The Honorable Sander Levin, Chairman
House Committee on Ways & Means
1236 Longworth House Office Building
Washington, DC 20515

The Honorable Charles Grassley
Ranking Member
Senate Committee on Finance
135 Hart Senate Office Building
Washington, DC 20510

The Honorable Dave Camp
Ranking Member
House Committee on Ways & Means
341 Cannon House Office Building
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Re: Request for Action on Pending Estate & GST Tax Legislation

Dear Chairmen Baucus and Levin, and Ranking Members Grassley and Camp:

We urge that Congress, before adjournment, address the limbo that legislative inaction has created for the nation's taxpayers. Specially, we ask Congress to resolve the systemic uncertainties resulting from the one-year suspension of the estate and generation-skipping transfer ("GST") taxes in 2010 and reinstatement of the 2001 transfer tax laws as of January 1, 2011, under the "sunset" provisions of Section 901 of the 2001 Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"). Our comments reflect our belief that taxpayers should not suffer worse tax consequences due to this one-year limbo than they would have otherwise, under either the pre-2010 or post-2010 law. We are concerned that the current uncertainty regarding application of the estate, gift and GST tax laws has created substantial obstacles for families and business owners trying to plan for the orderly transfer of their assets. Because the uncertainty was created legislatively, we believe its resolution requires legislative action, as it does not appear that the Treasury Department or the Internal Revenue Service would have the authority to resolve all of the numerous issues through rulings, regulations or other issuances.

By this letter, we seek to identify several of the most urgent issues requiring immediate resolution. We do not seek to review the extensive discussion of the numerous technical issues described in the comprehensive report that we submitted on December 7, 2004, as two of the sponsoring organizations of the Report on Reform of Federal Wealth Transfer Taxes ("the Report").[1] In addition, the Section of Taxation of the American Bar Association also previously explained the uncertainties resulting from the current transfer tax laws by letter to you dated April 5, 2010, a copy of which is enclosed.

Members of Congress have voiced many different positions about the proper approach to the transfer tax laws during the past several years. We do not take a position on the policy decisions that Congress must make in fashioning these tax laws, but believe that Congress must provide certainty regarding the general structure of the unified estate, gift and GST tax system. Attorneys around the country tell us that many Americans have been paralyzed in their basic estate planning, for fear that the final regime that Congress enacts may result in adverse tax consequences or require a new estate plan.

[1] Available at www.abanet.org/tax/pubpolicy/2009/090714abasectaxandrealproptrustlawstatementofpolregardingreformoffederalwealthtransfertax.pdf

An initial uncertainty that Congress should address is whether any legislative changes in the transfer tax system will be applied retroactively to events that occurred prior to the enactment of such changes. Given the significant time that has elapsed since the estate and GST tax were suspended on January 1, many of your colleagues have suggested that retroactive estate or GST taxation is no longer feasible. Alternatively, some have suggested that if the estate tax will be imposed retroactively, such taxation might be elective, so that an estate could opt for the estate tax with the normal basis adjustment rules of IRC § 1014 or elect to be subject to the modified carryover basis rules of new IRC § 1022. Although such an election might mitigate the public perception of unfairness and avoid the attendant litigation resulting from retroactive application of the federal estate tax, it would not resolve the myriad technical problems with application of modified carryover basis detailed in the Report.

However Congress chooses to proceed with respect to a retroactive application of estate or GST taxation, there are many technical issues that are important to resolve, the most significant of which are described below:

1. If the estate tax is applied retroactively, families of decedents who have died in 2010 should have the opportunity to restructure their decedents' estate plans to create the type of deductible dispositions that are common when planning for the estate tax. For example, many individuals plan to leave their estate to their spouses, so that no estate tax is incurred at the first spouse's death (because assets passing to a spouse qualify for the estate tax "marital deduction"). If an individual left her estate to her children because she believed that the estate tax would not apply to her 2010 estate, and if Congress retroactively imposes the estate tax, those children should have the ability to decide to allow the assets to pass to the decedent's husband (or a qualifying marital trust), so that the estate will qualify for the marital deduction, in order to defer the imposition of estate taxes until her husband's subsequent death.

2. Similarly, if the GST tax laws are applied retroactively, or if the 2010 gift tax rates were increased retroactively, donors should have the right to restructure or rescind transfers that were made in 2010 in reliance on the suspension of the GST tax in 2010 or on the application of a maximum 35% gift tax rate. If those rescissions or restructurings are permitted under local law, they should be respected for federal tax purposes.

3. The GST tax does not apply to GSTs that occur in 2010 (such as gifts to grandchildren). While that is clear, there are many issues causing confusion, which could be resolved if IRC § 2664 were revised to clarify that the GST rules and definitions of Chapter 13 *otherwise* continue to apply during 2010. For example, substantial confusion exists as to whether property that is transferred by a GST in 2010 to trusts, custodianships or guardianships for grandchildren will be subject to GST tax in a later year when distributed to individual grandchildren. A clarifying revision to IRC § 2664 would resolve this uncertainty. Alternatively, Congress could choose to revise the Internal Revenue Code to provide that, just as trusts funded prior to the enactment of the GST tax are not subject to the GST tax regime (unless assets are later added to such trusts), then assets transferred to trusts in 2010 would likewise not be subject to the GST tax regime in future years, unless assets are later added to those trusts.

4. As noted, the GST tax does not apply to GSTs in 2010, so there is no express GST exemption that exists this year. This means that no GST exemption can be allocated to such transfers to protect them from the imposition of GST tax when distributions are made to grandchildren in the future. Because no GST exemption exists in 2010, considerable uncertainty exists as to how to avoid such future GST tax. To alleviate this uncertainty, we suggest clarification of the GST tax rules to treat the taxpayer as having the amount of GST exemption in 2010 that the taxpayer would have had under pre-EGTRRA law based on the "sunset" provisions in Section 901 of EGTRRA.

Alternatively, we suggest that Congress allow taxpayers to allocate their GST exemptions available in 2011 to 2010 transfers as of the time the gifts were made in 2010, just as taxpayers normally can make timely allocations of their GST exemption available in the year of transfer under the laws that apply in all other years.

5. EGTRRA enacted GST tax rules to facilitate proper compliance and efficient administration, which were not based on changes in the GST exemption or GST tax rate. In particular, these include rules clarifying valuation for purposes of determining a final inclusion ratio and allowing automatic allocations of GST exemption to indirect skips, relief to make allocations that were missed but will be treated as timely made, retroactive allocations upon the untimely death of a child, and qualified severances. We suggest preservation of all of these GST administrative rules that were enacted under EGTRRA.

6. The estate tax also does not apply to estates of decedents dying in 2010. Similar to the GST tax, many issues causing confusion could be resolved if IRC § 2210 were revised to clarify that the estate tax rules and definitions of Chapter 11 *otherwise* continue to apply during 2010. For example, some wills or revocable trusts contain bequests or provisions for allocating administrative expenses determined by reference to the amount of the gross estate or referring to deductible expenses for federal estate tax purposes. Other wills or trusts make charitable bequests that are dependent on the bequests qualifying for the federal estate tax charitable deduction.

7. Section 901 of EGTRRA provides for the “sunset” of all EGTRRA provisions, requiring the tax law to be applied from January 1, 2011, as if EGTRRA “had never been enacted.” This provision has created a host of uncertainties regarding the transition rules as to what laws will apply after 2010, in light of the one-year hiatus of the estate and GST tax in 2010. In particular, there are many uncertainties under the GST tax transition rules and those rules should be clarified to avoid taxpayer confusion (and the potential for years of lawsuits) over the interpretation of these rules. The degree of uncertainties under these transition rules cannot be overstated and are described in the Report at pages 14-19. Clarification is imperative to avoid substantial administrative burdens on both taxpayers and the government, and unfairness to taxpayers who acted in reliance on those rules.

8. As noted (and as the Report detailed in more than 65 pages), the carryover basis rules will be extremely difficult to administer. Many families have no idea of the basis of assets that decedents have held for many years. Compliance with the carryover basis rules of IRC § 1022 will require significant resources of both taxpayers and the IRS, to implement a program that will apply only to beneficiaries of estates of decedents dying in 2010. It is up to Congress to weigh the advantages and disadvantages of a carryover basis system, but there can be little doubt that implementing such a system will be technically complex and administratively burdensome.

We urge Congress to pass legislation promptly to provide the certainty and stability that taxpayers deserve in the transfer tax system.

These comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law and Section of Taxation. These comments have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

Although the members of the Sections who participated in preparing these comments have clients who would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

Sincerely yours,

Alan F. Rothschild, Jr. Chair, ABA Section of Real Property, Trust and Estate Law	Charles H. Egerton Chair, ABA Section of Taxation

Enclosure
cc: Honorable Timothy F. Geithner, Secretary, Department of the Treasury
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service
Honorable Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
Mr. John L. Buckley, Majority Chief Tax Counsel, House Ways and Means Committee
Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee
Mr. Jon Traub, Minority Staff director, House Ways and Means Committee
Mr. Kolan Davis, Minority Staff Director, Senate Finance Committee
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation

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eReport conversation with Ed Koren

On December 10, 2010, eReport Editor Robert Steele and eReport TE editor Anta Cissé-Green spoke at length with Ed Koren, former chair of the RPTE Section, and chair of the Section's Task Force on Transfer Tax reform, which wrote the Section's recent letter to Congress, by phone from Ed's firm's Atlanta office at 10:30 am, which was only two hours after the text of the bill was made public.

eReport: Good morning, Ed, and thank you very much for your time. Before we talk about the specifics of the Section's letter to Congress, can you update us on the latest developments?

Ed Koren: There is a lot going on – a whole lot has gone on since about 8:30 this morning. The text of Senator Reid's bill [introduced late on Thursday, December 9, 2010] has been released. We are trying to parse through it and we have six people from our firm going through the implications of this bill, assuming of course that it passes and becomes law.

eReport: So the [Senator] Baucus bill is dead. We don't have to look at it?

Ed Koren: The Baucus bill is dead. The Senate bill would give us an estate tax beginning this year with a $5 million exemption, a unified system, an inflation index, and a 35% tax rate.

eReport: "Unified" -- meaning the estate tax and the gift tax will both have $5 million exemption?

Ed Koren: Yes, after 12/31/10. We will have a top tax rate of 35% for all three [estate, gift, and generation skipping transfer tax], an election for 2010 estates to opt out of the estate tax and opt over to carry-over basis.

eReport: Right. That works for large estates, but it sounds like a lot of small estates will be going the other way and opting for the estate tax since they will be under the exemption and will get the step-up in basis.

Ed Koren: Absolutely. The decision to get stepped-up basis will be particularly important for many 2010 estates, so they will not elect out of the new law.

There is another major provision for 2010, however. That is a provision for a GSTT exemption of $5 million and a 0% GST tax rate for 2010 transfers.

eReport: So somebody in the next few weeks can make a major gift and be free of any generation skipping transfer tax.

Ed Koren: Yes. There is a $5 million exemption that can be used for current transfers to a multiple generation trust and make a 2010 GST allocation to make the trust permanently exempt.

Alternatively, if you have a really big transfer and it is direct skip, you could make a $100 million direct skip, or make a taxable distribution from an existing non-exempt trust. Then the entire transfer would be at a 0% tax rate if made before 12/31/10.

eReport: Very interesting. What else is surprising in the bill?

Ed Koren: After 2010 we get portability.

eReport: So the new bill does have portability.

Ed Koren: Only for two years.

eReport: All of this is only for two years, right?

Ed Koren: Yes

eReport: Is this from the "framework" deal or is this new? Or we don't know because the framework didn't have any details?

Ed Koren: This is very different from the Baucus bill, so I must say that it is new, but as you say, the framework did not have details.

eReport: Is the bill widely seen as having a real shot at getting passed?

Ed Koren: It will pass the Senate. The issue is what happens in the House and whether Speaker Pelosi backs off her threat to not even bring it up. Either way, if it does not come up for a vote now, it will likely get passed in January with the new Congress. Whether everything in the bill remains the same or not, I don't know.

eReport: The problem is that everyone's income tax withholding is going to go up on January 1. That is the real trigger to get people to move.

Let's discuss other specifics of the proposal, assuming that it, or something similar will pass – even if the dollar amounts change, perhaps the technical concepts will remain. The estate tax would be retroactive but it would be optional. An estate can opt out of the estate tax and have the modified carryover basis system. Or is it the other way around?

Ed Koren: I think it is the former – the estate tax is the default result. The actual language of the bill is very cumbersome. We have to go back to the text of EGTRRA and work through the references. We look at §301C of the bill. Then, notwithstanding A, the case where a decedent dies after 12/31/09 but before 1/1/11, the executor may elect to apply as if the amendments made by A do not apply with respect to chapter 11 and with respect to property acquired by the passing by such decedent in the meaning of 1014(b). What does that mean? We have to work through the provisions.

eReport: It is a triple negative and we have see if the result is automatic estate tax with opt out for carry over basis..

Ed Koren: I believe that it is an opt out of the estate tax. I also think that for 2010 the exemption is $5 million. Beginning on January 1, 2011 the gift tax exemption also will be $5 million, so we finally have achieved re-unification. In 2010 you can either have a $5 million estate tax exemption or you can opt out of that and into the carry over basis provisions of §1022.

eReport: Which is the better thing to do. Then, people with smaller estates who don't do anything will get the step-up in basis automatically. We can assume that people with larger estates will be properly advised by counsel.

Ed Koren: Right

eReport: Let's talk about the Section's letter to Congress. The most interesting proposal or suggestion in the letter was the very first one, which was fascinating. The letter is suggesting a reformation of estate plans of people who already died. How was the drafting committee thinking that would work?

Ed Koren: That dealt with the situation where somebody who died in 2010 made a transfer in a will or trust and the issue is the way it gets interpreted. There could be a credit shelter trust and depending on interpretation, either everything went to the kids under the credit shelter or nothing goes to the credit shelter and all goes to the marital residuary. I have heard of several major estates, some in the last two weeks. I am glad I am not a fiduciary in any of them. There could be very difficult choices. I really think that is going to be an issue if it is a non-family beneficiary, or a second marriage.

eReport: Yes, it can affect different people in different ways.

Ed Koren: I understand that. Assume your parent died, you have another parent still alive. Then, it depends on whether you are in one of the 18 states and DC that has legislation on the interpretation of the credit shelter language. Lets pick California, which does not have legislation. The parent dies and the document says "I give the maximum amount to the credit shelter trust – generation skipping trust" and you go in and say that is the whole estate.

eReport: If the estate tax applies then the bequest is capped at $5 million, but if it does not apply then the bequest is unlimited.

Ed Koren: Right. The really interesting thing is that last minute enactment may create problems in states that do have legislation, for the question will be whether the estate tax "is applicable?" Does that reference refer to any estate in the particular state or just that estate, where the executor could opt out?

eReport: So your election there would affect the amount of the credit shelter trust.

Ed Koren: Right, so that is where there could be some issues. There is a whole host of things here.

eReport: They sure gave us a handful.

Another suggestion in the letter is to allow the re-structuring of 2010 gifts.

Ed Koren: Yes**.** Suppose you made a gift in June of $20 million because you ran the numbers on how much benefit you get, assuming the 35% gift tax rate. Then, what if Congress came back and said no, it was 45%. We want to be able to unwind the transaction if it no longer makes sense. Now, with the new proposal, it looks like the rate is 35%, so that our suggestion is not applicable.

No doubt we have a lot of confusion now. It reminds me of the period in 1976 when there was a transition rule for transfers between September 1976 and December 1976. I know that most of the "younger" lawyers don't remember this. Before the credit was unified, there were different rates and different exemptions. Making gifts during that period saved exemption. I was making tons of gifts for clients. I was a very young lawyer and this was before word processing. We had mag cards instead of computers. I had more secretaries than any other lawyer at the firm for about two and a half months because we were redoing so many trusts. I was running five secretaries! That is the closest I can think of to the situation now, but then at least we knew what the law was.

eReport: Right. Now we don't know the law and the IRS doesn't know the law. They come out with pronouncements saying we can't even tell you what the law is. Also, the form [for stepped-up basis] and all of that was retracted -- they will have to start over again.

Ed Koren: That is another problem. You have to deal with your tax return.

eReport: Right

Ed Koren: This is another area where the bill is very helpful. It provides an extension of the time to file either the estate tax return if the default rule is used, or the carry-over basis return if there is an opt out, until at least nine months after the date of enactment. There is also a similar extension for GST returns. In addition, and most importantly, there is an extension of time to pay the estate tax if the default rule is allowed to operate. Finally, the bill extends the nine month period under §2518 for disclaimers until nine months after enactment, although there may be some problems with state statutes or an acceptance of benefits issue that would have to be looked at.

eReport: Is there anything in the letter that you want to discuss?

Ed Koren: I think the proposal kind of cleaned up the issues we address in point 3. I also think they addressed point 4. Point 5 may not be addressed and that may be a concern -- trying to find out the qualification severance and all of those provisions could be an issue. If so, we want to see if they can pull something together on that.

eReport: There will be technical corrections for sure.

Ed Koren: If my read on the proposal is correct, then you opt out of the $5 million estate tax and this would mean that point 6 was addressed. Also, point 7 is addressed. The issues in point 8, if you opt for carry-over basis, have not been addressed at all. I think that covers our points in the letter.

eReport: Bottom line – we have confidence that if a bill passes, whether it is this year or next year, that Congress is taking into consideration the issues that the Section has raised concerning the technical problems.

Ed Koren: Yes

eReport: That is probably the best news of all.

Ed Koren: Right

eReport: This bill can totally crater [for political reasons] but we have confidence that when we have a new bill that they at least understand the issues because of the work the Section has done.

Ed Koren: Yes. I hope this helps

eReport: We greatly appreciate your time today.

Complex Securities Laws and the Eligibility of Trusts to Make Alternative Investments

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I. Uniform Prudent Investor Act

The Uniform Prudent Investor Act ("UPIA") reflects a "modern portfolio theory" and "total return" approach to the exercise of fiduciary investing. The UPIA removed much of the common law restrictions on the investment authority of fiduciaries and replaced the former Prudent Man Rule. As a result, a trustee's performance is measured by the investment performance of the entire portfolio. A trustee is now required to use modern portfolio theory and a sophisticated risk-return analysis to guide investment decisions. This has caused trustees to shift their focus to asset allocation and diversification in addition to security selection. Diversification plays a critical role in terms of reducing risk and volatility while maintaining or improving returns.

With the shift to modern portfolio theory under the UPIA, no category or type of investment is deemed inherently imprudent per se. In fact, an appropriate asset allocation and diversification strategy (one that maximizes return while minimizing risk and volatility) may include investments in derivatives, futures, commodities and other investments which may hedge investment risk. For most trustees, access to these types of investments is through unregistered limited partnerships and other private investment vehicles. For the trustee, and the legal professional advising the trustee, this requires an understanding of federal and state securities laws and regulations governing such investments in order to assess and advise whether a trust is legally permitted to make an investment in such an investment vehicle.

II. The Framework of Securities Regulation

Securities transactions are subject to regulation under both federal and state laws. The purpose of these laws is to ensure that investors have been provided sufficient financial and other information about the security being offered as well as the financial condition and investment policies of the issuer so that investors can make knowledgeable and informed investment decisions. In addition, laws and regulations are in place to prevent deceit, misrepresentation and fraud in the sale of securities. While there are many laws that govern the securities industry, for purposes of our discussion, we will focus on the federal laws in this area, specifically on the *Securities Act of 1933* and the *Investment Company Act of 1940.*

1. <u>Securities Act of 1933</u>

The Securities Act of 1933 (the "1933 Act") regulates public offerings of securities. It prohibits offers and sales of securities which are not registered with the Securities and Exchange Commission (the "SEC"), unless exempted from registration in accordance with the 1933 Act. Underlying the 1933 Act is the idea that an "issuer" offering securities should provide potential investors with sufficient information about both the issuer and the securities offered by the issuer to make an informed investment decision. The 1933 Act requires issuers to publicly disclose significant information about themselves and the terms of the securities.

2. <u>Investment Company Act of 1940</u>

The Investment Company Act of 1940 (the "1940 Act") regulates investment advisors. Investment advisors are companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities may be offered to the investing public. The 1940 Act requires these companies to register with the SEC and to disclose their financial condition and investment policies to investors when their stock is initially sold and regularly update such information thereafter. The focus of the 1940 Act is on disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations.

As noted above, the 1933 Act and the 1940 Act govern the registration of certain securities and issuers with the SEC. However, both of these Acts provide various exemptions from registration for certain securities and certain issuers. In the case of the 1933 Act, Regulation D (“Reg. D”) contains three rules (Rules 504, 505 and 506) providing exemptions from securities registration requirements, allowing some companies to offer and sell their securities without having to register the securities with the SEC. Specifically, Rule 506 permits an unlimited offering of unregistered securities to certain sophisticated investors defined as ***Accredited Investors***. In the case of the 1940 Act, Section 3(c)(7)(A) exempts from the definition of investment company any issuer whose securities are owned exclusively by sophisticated investors defined as ***Qualified Purchasers.***

III. Trust Investments in Unregistered Private Investment Vehicles

Trustees and advisors of trusts with certain minimum asset values should consider unregistered private investment vehicles (such as limited partnerships) as a component of a well diversified portfolio. In addition to broadening diversification, private investment vehicles may provide an opportunity to enhance returns as well as reduce the overall risk of the portfolio. These vehicles provide access to markets such as commodities, currencies, global bonds, real estate and private equity. Generally speaking, access to these types of asset classes are commonly offered through unregistered private investment vehicles.

Private investment vehicles and partnerships avoid SEC registration by limiting their securities offerings to accredited investors and/or qualified purchasers. For the trustee, and the advisor to the trustee, the key to understanding whether a trust can invest in such vehicles is an understanding of whether a trust meets the requirements of an accredited investor and/or qualified purchaser.

IV. Accredited Investor

An issuer of securities will often seek to avoid registration of its securities under the 1933 Act by limiting the securities offering to purchasers who are "accredited investors." Pursuant to Rule 506 of Regulation D, an issuer can sell an unlimited amount of securities to any number of accredited investors while being exempt from the registration requirements of the 1933 Act. Pursuant to Rule 501, an accredited investor is defined as any person who comes within eight categories set forth therein, or who the issuer reasonably believes comes within those categories, at the time the securities are sold.

The federal securities laws define the term accredited investor in Rule 501 of Regulation D as:

1. *Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of*

such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

2. *Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;*
3. *Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;*
4. *Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;*
5. *Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;*
6. *Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;*
7. *Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii); and*
8. *Any entity in which all of the equity owners are accredited investors*.

The foregoing exceptions are aimed at identifying individuals and entities that have the requisite sophistication to invest in higher risk assets without the need for the information and disclosures an issuer must make in a public offering of its securities. These investors are deemed to be sophisticated enough to understand the nature of the risk, the limited liquidity of the investment and the characteristics of the deal such that they can evaluate the merits of the offering independently. Rule 501 often uses net asset value as a proxy for determining sophistication. For example, an individual with a net worth in excess of $1 million or a trust with an asset value in excess of $5 million is deemed to be sophisticated enough to appreciate the risk of an unregistered securities offering.

1. <u>Irrevocable Trust</u>

Whether an irrevocable trust is an accredited investor depends on the facts and circumstances surrounding the trust. Recalling that Rule 501 aims to identify those investors of a certain sophistication, it is understandable that a trust's qualification as an accredited investor will not depend on the sophistication of the beneficiaries, but rather the sophistication of those with authority to make the investment on behalf of the trust.

A. Trusts with Assets in Excess of $5 Million

Rule 501(a)(7) provides that an irrevocable trust can qualify as an accredited investor if the assets of the trust are in excess of $5 million, the trust was not formed for the purpose of acquiring the securities offered and the purchase is directed by a 'sophisticated person.' A sophisticated person is described in Rule 506(b)(2)(ii) to be a purchaser who, either alone or with a purchaser representative, has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of a prospective investment.

B. Trusts Managed by a Bank or Investment Company

Alternatively, a trust of any size may be an accredited investor under Rule 501(a)(1) so long as a bank, insurance company, registered investment company, business development company, or small business investment company is serving as a trustee and/or has authority to make investment decisions on behalf of the trust. The SEC has determined that while a trust standing alone may not be an accredited investor under Rule 501(a)(1), if a bank is its trustee and makes the investment on its behalf, the trust will be accredited by virtue of the bank's status as an accredited investor under Rule 501(a)(1).[i] The same is the case for a trust with a bank acting as co-trustee, so long as the bank is acting in its fiduciary capacity on behalf of the trust with respect to investment decisions and the trust follows the bank's direction.[ii]

2. <u>Revocable Trusts and other Trusts</u>

Similar to irrevocable trusts, revocable trusts can qualify as an accredited investor under Rule 501(a)(7) and 501(a)(1). In addition, Rule 501(a)(8) provides that an entity in which all of the equity owners are accredited investors is an accredited investor. However, in the case of an irrevocable trust, the trust beneficiaries are not considered to be 'equity owners' and it is not the case that if all of the trust beneficiaries are accredited investors the trust is an accredited investor. The result is different in the case of a revocable trust where the trust is established by the grantor(s), (often created to facilitate the distribution of an estate in the event of death), during the life of the grantor(s) the trust may be amended or revoked by the grantor(s) and all the tax benefits of investments made by the trust pass through to the grantor(s). In this case, the grantor(s) is considered the 'equity owner' and if each grantor is an accredited investor under Rule 501(a)(5) or Rule 501(a)(6) (i.e. they meet the net worth or income tests), the trust is an accredited investor.[iii]

Rule 501(a)(8) also provides the path for an individual retirement account ("IRA") to qualify as an accredited investor. In the case of an IRA, the participant is deemed to be the equity owner and if the participant is an accredited investor under Rule 501(a)(5) or Rule 501(a)(6), the IRA is deemed to be an accredited investor.

Finally, there are some limited instances where the grantor of an irrevocable trust would be considered an equity owner of the trust under Rule 501(a)(8). In the case of a trust where the (1) trust is a grantor trust for federal income tax purposes with the grantor as the sole funding source, (2) grantor is the trustee with sole investment discretion, (3) entire amount of the grantor's contribution plus a rate of return would be paid to the grantor prior to any other payments, and (4) assets held by the trust are subject to the claims of the grantor's general creditors in the event of bankruptcy, the SEC has stated in an interpretive letter that the grantor of such a trust would be considered the equity owner and if the grantor was an accredited investor, the trust would be an accredited investor.[iv]

V. Qualified Purchaser

Similar to the case where an issuer of securities may seek to avoid registration of their securities under the 1933 Act, an issuer may also seek to avoid registration as an investment advisor by limiting securities offered to purchasers who are "qualified purchasers." Under Section 3(c)(7)(A) of the 1940 Act an issuer is excluded from the definition of an investment company, and hence exempt from registration as an investment company, if the securities offered by the issuer are owned exclusively by persons who are qualified purchasers. Similar to the rationale for exemption from registration under the 1933 Act, the SEC believes that if the offering is limited to sophisticated investors, those investors can adequately safeguard their interests without extensive federal regulation. There is, however, a higher threshold for a qualified purchaser under the 1940 Act than for an accredited investor under the 1933 Act, but net worth again serves as a proxy for sophistication. Section 2(a)(51)(A) of the 1940 Act created four categories of persons or entities who can be considered qualified purchasers: (i) individuals with at least $5 million in investments; (ii) family-owned companies with at least $5 million in investments; (iii) certain trusts in which the trustee and each settlor are qualified purchasers, and; (iv) companies with at least $25 million in investments.

The federal securities laws define the term qualified purchaser in Section 2(a)(51)(A) of the 1940 Act as:

> *(i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) [15 USCS § 80a-3(c)(7)] with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission;*
>
> *(ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;*
>
> *(iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or*

(iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.

1. Irrevocable Trust

There are two primary means by which an irrevocable trust can meet the requirements of a qualified purchaser. The requirements of Section 2(a)(51)(A)(ii) and Section 2(a)(51)(A)(iii) can be applied to an irrevocable trust.

A. Family-owned Companies with at Least $5 Million in Investments

Section 2(a)(51)(A)(ii) provides that any company that owns not less than $5 million in investments and is owned directly or indirectly by 2 or more persons of a certain family relationship (or estates, organizations or trusts established by or for the benefit of such persons) is a qualified purchaser. As it is used in Section 2(a)(51)(A)(ii), "company" is defined in Section 2(a)(8) of the 1940 Act to include a trust. In addition, Rule 2a51-1(b) generally defines "investments" as, among other things, certain securities, real estate held for investment purposes, commodities and interests therein, financial contracts, and cash and cash equivalents.[v] It is important to note, however, that real estate used by the prospective qualified purchaser for personal purposes or, in some instances, as a place of business, shall not be considered real estate held for investment purposes.

The 1940 Act does not define who the "owners" of a company are, however the Staff of the SEC ("Staff") has stated that the beneficiaries of certain family trusts could be considered the "owners" for purposes of Section 2(a)(51)(A)(ii) when those beneficiaries are the only persons holding economic interests in the trusts. Furthermore, the Staff stated in the Meadowbrook Real Estate Fund No-Action Letter (August 26, 1998) ("Meadowbrook") that it believed that Congress intended that all economic interests in a company that relies on Section 2(a)(51)(A)(ii) be held exclusively by persons who satisfy the family relationship requirements of that section. Therefore, in the case of a trust, all the beneficiaries of the trust must be related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons.

Meadowbrook re-affirmed the requirement in Section 2(a)(51)(A)(ii) that there be at least *two or more* natural persons (or estates, organizations or trusts established by or for the benefit of such persons) who are beneficiaries of the trust. In Meadowbrook, five trusts were seeking to meet the requirements of a qualified purchaser. Four of the trusts had two or more beneficiaries that met the family relationship requirement as well as all the other requirements of Section 2(a)(51)(A)(ii) and therefore met the requirements of a qualified purchaser under Section 2(a)(51)(A)(ii). In the case of the fifth trust, the trust was established for a single beneficiary and therefore the petitioners believed the trust could not satisfy the two or more requirement of Section 2(a)(51)(A)(ii). As a result, the petitioners sought and received qualification for the fifth trust under Section 2(a)(51)(A)(iii).

B. Trusts in Which the Trustee and Each Settlor are Qualified Purchasers

Section 2(a)(51)(A)(iii) defines a trust as a qualified purchaser if (1) the trustee or other person authorized to make decisions with respect to the trust and (2) each settlor or other person who has contributed assets to the trust, is each a qualified purchaser. This section is premised on Congress' belief that certain persons, at the time of making the investment decision, should have the financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the 1940 Act.[vi] It is also premised on Congress' intent that the person whose assets are at risk be able to appreciate the risks presented by an investment pool that is not subject to regulation.[vii]

To determine who must be a qualified purchaser, the SEC looks at the trustee (or other authorized person such as an investment advisor) who is responsible for making the investment decision, and therefore responsible for assessing the risks associated with the investment. If the trust has more than one trustee, the SEC only requires that the entity responsible for making the investment decision be a qualified purchaser.[viii] If more than one trustee is responsible for the trust's investment decision, each such trustee would need the required sophistication to evaluate the risks of the investment as a qualified purchaser. As such, each trustee's status would need to be considered.

The determination of whether a settlor is a qualified purchaser is made at the time he or she contributed assts to the trust.[ix] The SEC takes the position that the settlor, or anyone who has contributed assets to the trust, would have to have been a qualified purchaser at least once when he or she contributed assets to the trust.[x] If the settlor was a qualified purchaser when he or she initially funded the trust, the settlor would not need to be a qualified purchaser when he or she made later contributions. Conversely, if a settlor was not a qualified purchaser when he or she initially funded the trust but was a qualified purchaser at any time that he or she made a later contribution, the settlor would also meet the requirement.

In Meadowbrook, the Staff answered the question of whether the qualified purchaser status of a deceased settlor needed to be considered. In Meadowbrook the petitioner contended that the Section

2(a)(51)(A)(iii) requirement that the settlor of the trust be a qualified purchaser should not apply when the settlor is deceased. The petitioner argued that in the instance where the settlor has died prior to the trust's acquisition of securities the deceased settlor's status should be irrelevant and the status of the trustees making the investment decisions should control the trust's qualified purchaser status. The Staff in Meadowbrook disagreed and stated that Congress expressly required that a settlor of a trust seeking qualification under Section 2(a)(51)(A)(iii) (or other person who has contributed assets to the trust) be a qualified purchaser. Specifically, the Staff stated they believed that Congress intended that the settlor have had the requisite degree of financial sophistication at the time the settlor contributed the assets to the trust.

In the case of very old trusts, the requirement that a deceased settlor had to have been a qualified purchaser at the time the trust was funded or at the time additional assets were contributed to the trust may pose a real challenge for trustees and their advisors. One way to determine whether a settlor who is long deceased was a qualified purchaser, is to consider whether the settlor, at the time he or she contributed assets to the trust, would have been worth $5 million or more in 1996 dollars (the date of the National Securities Markets Improvement Act of 1996 that added Section 3(c)(7) and Section 2(a)(51)(A)(iii)).[xi] Considering a deceased settlor's worth in 1996 dollars would appropriately identify a settlor who would have had the requisite financial sophistication to be considered a qualified purchaser at the time of his or her contribution to the trust. Even though such a settlor may not technically have been in possession of investments valued at $5 million at the time, the value of such investments may be adjusted by using the Consumer Price Index, which captures changes in value over long periods of time.

The foregoing approach was used by the petitioner in the Trusts under the Will of Marion Searle No-Action Letter (March 29, 2005) ("Searle"). The petitioner in the Searle was seeking qualified purchaser status for several trusts that were funded upon the death of Marion Searle in 1959. The petitioners were able to show that the Settlor owned $3,215,000 in investments in 1959 dollars. Adjusting this amount by using the Consumer Price Index, the petitioners were then able to show that the settlor exceeded by a significant margin the $5 million dollar qualified purchaser threshold.

Alternatively, a trust that was itself worth $5 million in 1996 could arguably be viewed as a proxy for the wealth of the settlor at the time the settlor contributed assets to the trust on the theory that, if a settlor contributed enough assets to the trust for the trust to be worth $5 million in 1996, then the settlor probably was worth at least $5 million (in 1996 dollars) at the time that the settlor contributed assets to the trust. The SEC, however, has not been presented with this situation and has not made this determination.

2. <u>Revocable Trusts and Other Trusts</u>

In determining whether a revocable trust is a qualified purchaser, Sections 2(a)(51)(A)(ii) and 2(a)(51)(A)(iii) also apply. In meeting the requirement under Section 2(a)(51)(A)(iii) that the settlor be a qualified purchaser, the Staff has stated that there may be other situations in which a settlor would have, at the appropriate time, the requisite financial sophistication to appreciate the risks presented by an unregistered investment, thereby satisfying the purpose of the settlor requirement that the settlor be able to appreciate the risks presented by an investment pool that is not subject to regulation under the 1940 Act. Specifically, the Staff noted that situations where the settlor has express authority to make the decision whether to invest, or has other rights with respect to the operation of the trust such as the right to revoke the trust or to change the trustees, and is a qualified purchaser, the settlor arguably could meet the qualified purchaser requirement at that time.[xii]

With respect to whether an IRA is a qualified purchaser, the SEC looks through the IRA to its creator.[xiii] When an entity, such as an IRA, acquires securities issued by a Section 3(c)(7) Fund, the entity is considered the alter ego of the investor. The SEC would consider the acquisition to have been made by the investor.[xiv] Therefore, the investor must individually meet the requirements of a qualified purchaser under Section 2(a)(51)(A).

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[i] *See* Interpretive Release on Regulation D, Release No. 33-6455, at Question 26 (March 10, 1983).

[ii] *See* NEMO Capital Partners L.P., SEC No-Action Letter (April 11, 1987).

[iii] *See Lawrence B. Rabkin, Esq*. No-Action letter re Rule 501(a) (8) of Regulation D dated July 16, 1982.

[iv] *See* Division of Corporate Finance Compliance and Disclosure Interpretations Re: Securities Act Rules (last updated September 14, 2009) *citing* Herbert S. Wander No-Action Letter (November 25, 1983).

[v] *See* Meadowbrook Real Estate Fund, SEC No-Action Letter (August 26, 1998).

[vi] *See* Meadowbrook *supra* at Note 5.

[vii] *See id.*

[viii] *See* American Bar Association No-Action Letter, at Section C, Question 1 (April 22, 1999).

[ix] *See* Meadowbrook *supra* at note 5.

[x] *See id*.

[xi] *See* Trusts Under the Will of Marion Searle, No-Action Letter (March 29, 2005).

[xii] *See* Meadowbrook *supra* at note 5.

[xiii] *See* ABA Letter *supra* at note 8 at Section B, Question 2.

[xiv] *See id.*

Irrevocable Trust

Accredited Investor

Trust

Accredited Investor 501(a)(7)

Trust with total assets in excess of $5,000,000 not formed for the specific purpose of acquiring the securities offered whose purchase is directed by a *sophisticated person*

Sophisticated person(s) directing purchase

Sophisticated Person: A person who has such knowledge and experience in financial and business matters that he/she is capable of evaluating the merits and risks of the prospective investment

Accredited Investor 501(a)(1)

Trust with total assets of any amount

Bank, investment company, etc. is acting in a fiduciary capacity serving as sole trustee or co-trustee

Irrevocable Trust

Qualified Purchaser

Trust

Qualified Purchaser 2(a)(51)(A)(ii)

Trust with assets of $5,000,000 or more, with two (2) or more beneficiaries, and all of the beneficiaries are natural persons related as:

- Siblings
- Spouses (including former spouses)
- Direct lineal descendents by birth or adoption
- Spouses of such persons
- Estates of such persons
- Foundations, charitable organizations or trusts established by or for the benefit of such persons

Qualified Purchaser 2(a)(51)(A)(iii)

Trust with total assets of any amount

Trustee(s) or Investment Advisor involved in making the investment decision is a Qualified Purchaser

AND

Each settlor or other person who contributed assets to trust is/was a qualified purchaser at the time of contribution/funding

Revocable Trust

Accredited Investor

Trust

501(a)(7)

Trust with total assets in excess of $5,000,000 not formed for the specific purpose of acquiring the securities offered whose purchase is directed by a *sophisticated person*

Sophisticated person(s) directing purchase

Sophisticated Person: A person who has such knowledge and experience in financial and business matters that he/she is capable of evaluating the merits and risks of the prospective investment

501(a)(1)

Trust with total assets of any amount

Bank, investment company, etc. is acting in a fiduciary capacity serving as sole trustee or co-trustee

501(a)(8)

Any entity in which all of the equity owners are accredited investors

Revocable Trust

Qualified Purchaser

Trust

Qualified Purchaser 2(a)(51)(A)(ii)

Trust with assets of $5,000,000 or more, with two (2) or more beneficiaries, and all of the beneficiaries are natural persons related as:

- Siblings
- Spouses (including former spouses)
- Direct lineal descendents by birth or adoption
- Spouses of such persons
- Estates of such persons
- Foundations, charitable organizations or trusts established by or for the benefit of such persons

Qualified Purchaser 2(a)(51)(A)(iii)

Trust with total assets of any amount

Trustee(s) or Investment Advisor involved in making the investment decision is a Qualified Purchaser

AND

Each settlor or other person who contributed assets to trust is/was a qualified purchaser at the time of contribution/funding

Trusts, Fiduciary Obligations and the Family Jet
By Michelle M. Wade and Dillon L. Strohm[i]

In the United States, aircraft may be registered in the name of the trustee of a trust provided they both satisfy the FAA requirements. With the July 20, 2010 publication of new regulations, Trustees became subject to new obligations to re-register aircraft every three years. Risks of failing to properly re-register an aircraft could include cancellation of the aircraft's registration, temporary grounding of the aircraft, loss of insurance coverage, breach of loan covenants and cancellation of a coveted N#.

Effective October 1, 2010, the FAA began to limit the duration of an aircraft's Certificate of Registration ("Certificate") to three years at which time the Certificate may be renewed for a successive three-year term upon completion and submission of a renewal request form and payment of the applicable fee. Previously, a Certificate did not expire. The stated goal of this massive undertaking by the FAA is to improve the accuracy of the Civil Aviation Registry database.

When required, a Trustee should promptly file re-registration and renewal applications. Owners must renew the registration and receive the renewed Certificate before expiration. If an owner renews after the registration expires, the aircraft will no longer be properly registered with the FAA and will not be operable. If the aircraft is on a Part 135 certificate, loss of charter revenue may also occur.

Approximately six months before an aircraft's Certificate expires, the FAA Registry is to mail a notice with instructions to the registered owner using the mailing address of record. The notice will identify the expiration date, and the three month window during which application must be made to ensure receipt of the new Certificate before the old Certificate expires.

The 3-month filing window occurs in the fifth, fourth and third months before expiration of the Certificate. A code is to be provided in the notice from the FAA Registry to allow on-line re-registration and payment of the fee when there are no changes in ownership, address, or citizenship. If there are any changes, the form must be printed, signed, and mailed with the fee.

At the end of the 3-month filing window, the opportunity for on-line re-registration closes. Remaining applications and fees must be mailed to the FAA Registry.

Two months before expiration, a second notice is to be sent to registered owners for which the Registry has not yet received an application for re-registration. Applications for registration may be submitted, but due to processing and mailing times, the aircraft may be grounded until re-registration is completed. Upon expiration of registration the owner is to be sent notice of the scheduled cancellation of the N-number and their option to reserve the N-number. Once cancelled, the N-number will not be available for assignment or reservation for five years.

Steps that a Trustee should take now include:
1. Contact your flight department to make sure they are aware of the new requirements and to ask them to look at the current Certificate to determine the month in which it was issued. This will allow both the Trustee and the flight department to calendar the anticipated re-registration filing window.

2. Either the Trustee or the flight department should look up each aircraft on the FAA's website and verify that the mailing address and the names of owner(s) shown are correct.

3. If any information is incorrect, the Trustee should consult with the user of the aircraft and work together to update the information.

Aircraft with a Certificate issued in March of any year are the first to face the re-registration process. Based on the above schedule, these owners should have received the first notice in October, 2010, with the following three months constituting the filing window. If no application is received the registration will be cancelled on March 31, 2011. Aircraft with a Certificate issued in April of any year should receive their first notice in January 2011 and will have a filing window from February 1 to April 30, 2011.

Addressing aviation issues can quickly become complex. Deciding how to best handle each issue varies from person to person. An attorney experienced in corporate jet registration and operations can assist by providing guidance on how to ensure FAA compliance while satisfying other goals.

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