2018-19 Section Leadership

The Section of Real Property, Trust and Estate Law welcomes its new leadership board:

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The ABA Section of Real Property, Trust and Estate Law Fellows Program encourages the active involvement and participation of young lawyers in Section activities. The goal of the program is to give young lawyers an opportunity to become involved in the substantive work of the RPTE Section, while developing into future leaders.

Each RPTE Fellow is assigned to work with a substantive committee chair, who serves as a mentor and helps expose the Fellow to all aspects of committee membership. Fellows get involved in substantive projects, which can include writing for a RPTE publication; become Section liaisons to the ABA Young Lawyers Division or local bar associations; become active members of the Membership Committee; and attend important Section leadership meetings.

The Section is excited to announce the 2018–2020 class of RPTE Fellows. After much discussion, the following individuals have been chosen to represent the Section for the 2018–2020 bar years:

**Trust & Estate Fellows**

Renee Salley  
The Salley Law Firm, LLC  
Cobb County, GA

Emily Plocki  
Venable LLP  
Washington, DC

Jessica Coutre  
Freeborn  
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Jacob Geierman  
Ohnstad Twichell  
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Jessica Diaz  
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Real Property Fellow

Erik Provitt
Atlanta Volunteer Lawyers Foundation
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Detroit, MI

Colleen MacRae
Nyemaster Goode PC
Des Moines, IA

Erica Menze
Alterman Law Group, PC
Portland, OR

Meredith Carpenter
Duane Morris
Philadelphia, PA

The Section also sends a huge thank you to the 2018 selection committee: Ryan Walsh, Robert Nemzin, Hugh Drake, Christina Jenkins, Toni Ann Kruse, Kathy Law, Joey Lubinski, Liz Ochoa, Karin Prangley, Rana Salti, and Jessica Uzgategui.
We are delighted to announce the winners of the 2018 RPTE Law Student Writing Competition.

First place: “State Theft in Real Property Tax Foreclosure Procedures” by Jenna Foos, Michigan State University College of Law.


Jenna Foos, the first-place winner, will receive $2,500 cash, a one-year free membership in the Section and free round-trip airfare and weekend accommodations to attend the Section’s Fall Leadership Meeting, September 27-29, 2018, in Chicago, IL. She is eligible for a full-tuition scholarship to the University of Miami School of Law's Heckerling Graduate Program in Estate Planning OR Robert Traurig-Greenberg Traurig Graduate Program in Real Property Development for the 2018–2019 or 2019–2020 academic year. In addition, Jenna’s essay will be considered for publication in a future issue of the Real Property, Trust & Estate Law Journal.

Courtney Bravo, the second-place winner, will receive $1,500 cash. Courtney’s submission will also be considered for publication in a future issue of the Real Property, Trust & Estate Law Journal.

Bonnie Daniels, the third-place winner, will receive $1,000 cash. Bonnie’s submission will also be considered for publication in a future issue of the Real Property, Trust & Estate Law Journal.

The goal of the RPTE student writing contest is to encourage and reward law student writing on the subjects of real property or trust and estate law. The essay contest is designed to attract students to these law specialties, and to encourage scholarship and interest in these areas. Articles submitted for judging are encouraged to be of timely topics and have not been previously published.

The ABCs of Leasing

**Pull Quote:** Leases should accurately reflect not only the term sheet economics, but also the allocation of responsibilities and liabilities that can impact or change the economic deal.

**Q: What are some of the basics of negotiating leases?**

Negotiating leases requires an understanding of the type of space being leased, how the rent economics are structured, and how services (including maintenance and repairs) are provided to the premises. Leases provide cash flow to pay expenses and fund improvements and can enhance the value of the property for financing and sale purposes. Each lease provision not only affects a client’s rights and remedies, but can significantly affect property value; accordingly, the division of responsibilities, both operationally and economically, needs to be accurately reflected. Always keep in mind the “ABCs of Leasing”:

**A – Ask** clients, property managers, and brokers the right questions to understand the context of the deal, “how the property works”, rights of existing tenants, and the key non-letter of intent (LOI) points to cover in the lease.

**B – Be** sure to factor in future flexibility when negotiating lease provisions.

**C – Cover** key points during the LOI stage, especially for significant leases.

**Q: Could you explain some of the different types of leases?**

**TS:** Office leases are typically modified gross structures, in which the landlord’s base line operating expenses and real estate taxes are included in the fixed rent (with tenants being responsible to pay increases in such base line amounts), and the landlord provides most of the services. Under industrial leases, tenants perform more obligations and pay more expenses, such that the base rent is “more net” to the landlord. In retail leases, tenants pay a fixed rent and typically pay a pro rata share of CAM charges and real estate taxes without a base year. Retail tenants often also pay a percentage of the tenant’s gross sales as additional rent.

**Q: What comprises the basic elements in a letter of intent?**

**TS:** LOIs set forth the road map for the deal. The larger the space or the longer the term, the more detailed the LOI should be. The LOI should identify the tenant (and, if applicable, the guarantor), address the rent economics, set forth the estimated delivery date and condition of the premises (including any landlord’s work obligations and TI allowances), and the security deposit, among other items. In addition, the LOI should spell out the length of the initial lease term, options to extend, and any parking or signage rights.
Q: How does leverage figure into negotiations?

**TS:** Understanding your leverage when negotiating a lease is very important. Tenants usually have maximum leverage at the LOI stage. Size and length of tenancy and the lease’s impact on the property’s valuation influence leverage, as do market conditions.

Q: How does the identity and credit of a particular tenant affect a property?

**TS:** The market reputation and credit of a particular tenant significantly influences how investors, purchasers, and lenders value a property. From the landlord’s standpoint, matching the financial statements provided prior to lease execution to the named tenant is very important. If the named tenant lacks sufficient credit (or does not have a separate balance sheet), landlords will often require a larger security deposit or a guaranty from the parent entity in connection with the lease.

Q: How do parties provide for future flexibility in leases?

**TS:** Tenants often negotiate for flexibility in assignment/subletting clauses, whereas landlords want to maintain control over who becomes its tenant. Because a corporation’s strategy and focus changes over time, many tenants (especially retailers) will also negotiate for a flexible permitted use clause. Tenants should take a long-term view by negotiating for an option to extend the lease beyond the initial term. If the tenant has leverage, it will negotiate for future expansion rights and, if possible, and the right to terminate the lease (or certain space) at an earlier date. Landlords will often want concessions from the tenant in return for granting these rights. Landlords will want to reserve, among other items, the right to relocate the tenant and make changes to its building and to enter the tenant’s premises for building repairs and alterations.

*Timothy M. Smith is a senior partner in Nutter’s Real Estate Department. Both public and private companies rely on Tim’s 30 years of experience in real estate acquisition, disposition, leasing, joint venture, and financing transactions. Tim also represents clients in land use and permitting matters, including subdivision, environmental, wetlands, and zoning issues.*
Are Condominium Assessments Dischargeable in Chapter 13 Proceedings?

By Manuel Farach

The answer is "yes" (under certain circumstances) according to a recent case from the Ninth Circuit Court of Appeals. **Goudelock v. Sixty-01 Ass’n of Apartment Owners**, No. 16-35385 (9th Cir. July 10, 2018). Specifically, the Ninth Circuit held that a pre-petition *in personam* debt (or "claim" in precise bankruptcy terminology) for assessments created when a property owner takes title to property which contractually obligates the owner/debtor to pay assessments is dischargeable when the owner/debtor successfully completes a confirmed Chapter 13 plan. While the statement itself appears complicated, analysis of the facts of **Goudelock** explains and clarifies the statement.

I. Facts

Penny Goudelock purchased a condominium unit in Redmond, Washington in 2001, and as expected, was given a deed to her unit subject to a previously recorded declaration of covenants and restrictions. And again as expected, the declaration provided that the condominium association could charge unit owners with assessments for the costs of running the association and the condominium and do so in two ways: having unpaid assessments become an enforceable lien against the owner's unit and also creating a personal obligation against the owners to pay the assessments. **Goudelock** at 3 – 4. It is the second right of the association, i.e., to charge the unit owner personally for unpaid assessments, that was in dispute in this case.

Goudelock stopped paying assessments in 2009 and the association began state court foreclosure proceedings. Goudelock responded by moving out of her unit and filing for Chapter 13 bankruptcy protection in March of 2011. Her confirmed Chapter 13 plan included a provision surrendering the unit, and the state court foreclosure sale was cancelled upon the mortgage lender paying the outstanding lien. The lender completed the state court foreclosure in February 2015 and Goudelock completed her plan obligations in July 2015 and received a discharge under 11 U.S.C. § 1328(a). However, Goudelock was not yet out of the woods as the association had brought suit in April 2015 to determine the dischargeability of Goudelock’s personal obligation to pay the post-petition assessments that accrued between the date when Goudelock filed her Chapter 13 petition (March 2011) and the date when the lender foreclosed on the unit in state court (February 2015). The dischargeability of this particular debt is the narrow issue the Ninth Circuit ruled upon.

II. Analysis

The Ninth Circuit began its analysis by first recognizing the issue of dischargeability of post-petition condominium assessments in Chapter 13 proceedings had never been addressed by a circuit court of appeal. Accordingly, it started by analyzing two circuit courts of appeal decisions that discussed whether post-petition assessments were dischargeable in Chapter 7 proceedings: **Matter of Rosteck**, 899 F.2d 694 (7th Cir. 1990) (obligation to pay condominium assessments is an unmatured
contingent debt that arises prepetition and is dischargeable), and In re Rosenfeld, 23 F.3d 833 (4th Cir. 1994) (obligation to pay cooperative association assessments run with the land and arise each month the debtor is in possession of unit). Applying a plain reading of Bankruptcy Code, the Ninth Circuit adopted the Rosteck approach and held that while the association's in rem lien against the unit was not dischargeable in Chapter 13, the pre-petition in personam obligation was indeed dischargeable.

The Ninth Circuit's analysis was an exercise in straightforward statutory analysis. First, the court reviewed Chapter 13 and recognized that a Chapter 13 discharge, with few exceptions, is a discharge of all "debts." 11 U.S.C. § 1328(a). In other words, a Chapter 13 discharge is a discharge that is broader than given in all other sections of the Bankruptcy Code. Goudelock at 8. Moreover, the definition of "claim" under the Bankruptcy Code is also very broad and encompasses all of a debtor's obligations "no matter how remote or contingent." Goudelock at 9, citing In re SNTL Corp., 571 F.3d 826, 838 (9th Cir. 2009) (quoting In re Jensen, 995 F.2d 925, 929 (9th Cir. 1993)) (emphasis in original). And in the view of the Ninth Circuit, the broadness of the Bankruptcy Code language indicated that the in personam obligation to pay association assessments was a "debt" subject to the super-discharge powers of Chapter 13 – even if the debt was contingent or unmatured.

The court next examined the timing of the obligation, and concluded that Goudelock's obligation to pay assessments was a "debt" created when she became the owner of the unit and not the result of a separate post-petition obligation, i.e., post-petition obligations being non-dischargeable. Thus, the debt arose pre-petition and was dischargeable unless a separate section of the Code provided the debt could not be discharged. Looking at Bankruptcy Code subsections 1328(a)(1) – (4) and noting that they enumerate the only exceptions to the broad discharge of debts under Section 1328(a), the Ninth Circuit held the debt was dischargeable because Congress did not specifically list condominium assessments as a non-dischargeable debt in Chapter 13 cases like it did for Chapter 7 cases in Bankruptcy Code 523(a)(16). Goudeck at 11. The Ninth Circuit found a specific exception to the discharge of condominium assessments in Chapter 7 proceeding, and found the exclusion of the exception in Chapter 13 to be purposeful, brushing aside arguments the exclusion was an oversight by Congress.

Likewise, the Ninth Circuit found the Takings Clause of the Constitution was not implicated because the association retained its in rem right to foreclose its lien, and that there were no "equitable" concerns (i.e., possible "free rent" by continuing to live in a unit post-petition without paying assessments) to its decision because any such equitable concerns could not override the express statutory language chosen by Congress.
III. Take-Aways

There are several items practitioners should focus on when confronted with a case similar to Goudelock. First, practitioners should examine under which Chapter of the Bankruptcy Code the debtor filed their petition for relief. If under Chapter 13, practitioners should keep in mind that it is difficult to confirm a plan under Chapter 13 and that conversion to Chapter 7 is often the end result of a Chapter 13 petition filing.

Second and despite the Ninth Circuit's dismissal of equitable concerns, one has to wonder whether a trial court bankruptcy judge would be more amenable to some form of adequate protection or required payment for residing in the unit during the pendency of a bankruptcy case. In that vein, keep in mind that Ms. Goudelock moved out of her unit approximately at the same time that she filed her Chapter 13 proceedings, meaning she was not living "rent free" for a significant period of time. We cannot speculate what the Ninth Circuit may have done had Goudelock attempted to discharge pre-petition obligations while living in the unit for several years, but litigants on the other side of that equation can argue that any such reading of the Goudelock opinion is dicta and cannot be relied upon.

Finally, practitioners may want to focus on the in rem remedies an association may have and concentrate their efforts in that arena. There remain a good deal of questions surrounding different scenarios arising out of the facts of Goudelock, but the in rem remedy continues to be a powerful and forceful way for associations to recover assessments.

IV. Conclusion

Goudelock provides an answer we have not had before that pre-petition condominium assessments are dischargeable in Chapter 13 proceedings, but leaves some crucial questions unanswered. This being the first circuit court case on the issue, chances are the other circuits may weigh in on the issue. Practitioners should be aware of Goudelock and its possible application to every Chapter 13 case where the debtor owns a condominium unit.

1 Manuel Farach is a Member in the Fort Lauderdale office of McGlinchey Stafford, PLLC, and serves as the Chair of the Section's Real Property Litigation and Alternative Dispute Resolution Committee. A more detailed biography of Mr. Farach can be found on his LinkedIn page at "Manuel Farach."
“Gross Up” Provisions in Office Leases

By

William M. Hof

Few concepts are as confusing as the “gross up” of operating expenses to those who do not regularly deal with office leases. Most tenants understand that in addition to base rent, tenants often directly reimburse their landlords for a portion of the building’s operating expenses (e.g., real estate taxes, casualty insurance, maintenance, utilities, etc.). However, calculating such reimbursement for multi-tenant office buildings is less intuitive.

Defining “Gross Up”

Stated simply, the concept of “gross up” is that, when calculating a tenant’s share of operating expenses for an office building that is less than fully occupied, the landlord first increases - or "grosses up" - those operating expenses that vary with occupancy (e.g., utilities, janitorial service, etc.) to the amount that such expenses would have been if the building were fully occupied. (In practice, “gross up” provisions are typically negotiated to reflect only 90-95% occupancy; however, for simplicity this discussion will consider only 100% occupancy.)

Understandably, many tenants’ initial reaction is to question why any operating expenses should be increased above the amount actually incurred, suspecting that the landlord is trying to convert the operating expense reimbursement into a profit center. In reality, the “grossing up” of operating expenses is a fair and necessary mechanism to ensure that the intended reimbursement is fully paid and, in some circumstances, to protect the tenant from overpaying operating expenses.

How “Gross Up” Works

Consider a hypothetical 10-story office building with 10,000 square feet per floor, for a total of 100,000 square feet in the building. If this building were leased to five separate tenants, each having one floor, each tenant’s proportionate share would be 10% (1/10 of the total building). Now suppose that the landlord’s annual operating expenses for this building were $100,000, comprised of $75,000 for fixed expenses, and $25,000 for expenses that vary with the building’s occupancy. If the operating expenses were not “grossed up,” each tenant would have to pay its proportionate share of the $100,000 operating expenses, or $10,000 for each tenant, comprised of $7,500 for fixed expenses and $2,500 for variable expenses.

However, even if the landlord were to collect the full $10,000 from each tenant, it would only collect a total of $12,500 towards the variable operating expenses ($2,500 x 5), which is only one-half of the $25,000 in variable operating expenses that the landlord
actually incurred. This results from the fact that each tenant’s proportionate share is the ratio of the tenant’s space to the total space in the building rather than the ratio of operating expenses attributed to the tenant’s space to the total operating expenses for the building.

To correct this, the variable operating expenses should be “grossed up” to the amount they would have been if the building were fully occupied. In the example above, if the variable operating expenses were $25,000 where the building is one-half full, presumably they would have been $50,000 if the building were fully occupied. If each of the five tenants pays its 10% proportionate share of the “grossed-up” operating expense amount of $50,000, they would each pay $5,000, and the landlord would collect a total of $25,000 in variable operating expenses, which is the amount of variable operating expenses that the landlord actually incurred.

**Variable vs. Constant Expenses**

Note that, in the example above, the only expenses that were “grossed up” were those expenses that vary with the occupancy of the building. Operating expenses that are constant regardless of the level of occupancy - such as real estate taxes and insurance - should not be “grossed-up.”

This means that the existing tenants in a building that is less than fully occupied will not reimburse the landlord for the full amount of such fixed expenses actually incurred. This is appropriate because the “gross up” provision should not be used to shift the risk of vacancy from the landlord to the tenant. The landlord is obligated to pay taxes, insurance, and the like regardless of the building’s occupancy, and it is the landlord’s business to fill its building with tenants to cover these fixed operating expenses.

To the extent that a “gross up” provision in a lease provides that operating expenses will be increased to the amount such expenses would have been if the building were fully occupied, it may not be strictly necessary to specify that only those operating expenses that vary with occupancy will be “grossed up” (after all, a fixed operating expense, by definition, will be the same at full occupancy as at any other level of occupancy); however, it is good practice to state in the lease that only variable operating expenses will be “grossed up”, as well as specify which operating expenses are considered variable.

**Tenant Protection**

While commonly considered a landlord protection (albeit a fair one), there are certain circumstances where “gross up” protects the tenant from paying more than its intended share of operating expenses.
For example, in many office leases, the tenant is obligated to pay only its proportionate share of operating expenses over a certain base year (usually the first year of the lease term). Suppose that a building is not fully occupied in the base year and base year operating expenses are not “grossed up.” If the building’s occupancy subsequently increases, the variable operating expenses will also increase as the new tenants require services (in addition to the increase attributable to inflation, etc.), and, because the tenant must pay its portion of the increase in operating expenses over the base year, the tenant would be obligated to pay a portion of the variable operating expenses attributable to new tenants.

Assuming the landlord is reimbursed for those expenses by the new tenants under their leases, the original tenant’s overpayment of operating expenses is a windfall to the landlord. Therefore, to prevent this unexpected spike in operating expenses in base year deals, tenants should ensure that the lease specifies that, in calculating the increase of operating expenses, the variable operating expenses for such base year and all subsequent years will be “grossed up.”

Contrary to a tenant’s natural reaction, the “gross up” of operating expenses in a multi-tenant office building is neither nefarious nor inappropriate. Rather, it is a mathematical necessity to ensure that the landlord receives full reimbursement for all of the operating expenses that vary with occupancy, as the parties intend. Moreover, where the tenant has negotiated for a “base year” with respect to operating expenses, the “gross up” of operating expenses actually protects the tenant from overpaying variable operating expenses as occupancy of the building increases after the base year.

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Taking the Plunge:  Key Considerations for Joint Ventures with Developers
By Andrea Saunders Rifenbark and Elizabeth A. Willes

Joint ventures between institutional investors and developers often present great opportunities for higher returns than stabilized properties. However, like all relationships, there are pitfalls and challenges of which to be wary and it is best to start the relationship built on a stable foundation of communication and trust, as well as an equitable spread of risk and reward.

The following is an overview of some of the matters investors should carefully consider before entering into a joint venture with a developer.

Choose the Structure

Unless there are particular tax concerns, the majority of joint ventures are structured as limited liability companies or limited partnerships. Limited liability companies are the simplest to form and provide the benefits of limited liability to its members while also offering flexible management and operation rights. Besides determining the best investment vehicle for a venture, an additional threshold matter to be decided is whether it will be a platform venture focusing on the acquisition and development of specified property types located in certain target markets or a venture for the development of an identified project or portfolio of related properties.

Determine Timing of Initial Investments and Contributions of Properties

It is not uncommon for a developer to acquire raw land or enter into a purchase agreement to acquire the land, and then attempt to bring in an investor to provide the capital necessary to complete the acquisition process and/or development of the property. As part of the discussion regarding the structure, the developer may suggest that it contribute a certain property or related group of properties as the initial investment(s) of the venture, which will impact the allocation of costs, risks and liabilities among the members upon the origination of the venture. For example, the developer may request reimbursement and/or upfront payments from the investor to cover its due diligence expenses, initial lender fees and other pre-development expenses. If the developer member has already entered into a purchase agreement, the investor must evaluate the risks of relying on the due diligence conducted by the developer during a time in which it was not subject to any standard of care set forth in the venture agreement.

If the developer already owns the property and desires to contribute the property and/or its membership interest in the existing entity that owns the property, the investor should obtain certain assurances in the form of indemnities and representations and warranties to mitigate the risks associated with occurrences at the property and actions taken by the developer and the owning entity prior to the closing of the contribution. An investment
into an existing entity adds another layer of complexity to the transactions since the investor will want entity-level as well as property-level representations and warranties, addressing matters such as pending litigation, financial status, tax payments, and other liabilities of the entity, so as to protect the investor from inheriting these pre-closing liabilities without any ability to allocate the responsibility to another party. Preferably, the entity-level representations and warranties and indemnities will have a sufficient survival period to mirror the long-term liability of acquiring an ownership interest and all assets and obligations associated with the entity. The parties should also discuss how the property will be valued for purposes of determining the initial actual or deemed capital contributions of the members as well as any tax consequences associated with the contribution of property to the venture.

Address Cost Overruns

One of the most negotiated provisions in a venture agreement pertains to allocating responsibilities for costs that exceed the approved budget, commonly referred to as cost overruns. On the one hand, the developer does not want to be responsible for cost overruns outside of its control, and on the other hand, the investor does want to be obligated to fund more capital than what it allocated to the project (and may not be able to do so without receiving investment committee approval for an increase).

The investor will want any cost overrun incurred by the venture due to the developer’s failure to comply with the applicable standard of care to be paid 100% by the developer. Developers often push back on this, advocating for the venture to pay any cost overruns that were not due to the developer’s own gross negligence, willful misconduct or other bad acts. However, this puts the venture at risk for cost overruns caused by mismanagement (i.e., simple negligence by the developer) and could result in the investor funding much more than originally planned in order to have the project completed.

Another good position for the investor is when the developer takes responsibility for 100% of the cost overruns up to a fixed dollar amount, so that the initial cost overruns to be funded in excess of the budget are borne by the developer. This approach incentivizes the developer to not exceed the budget since it alone must fund such initial cost overruns. Cost overruns due to force majeure are usually excluded, with the venture being responsible for costs overruns incurred due to unforeseen weather delays, labor strikes, etc. (although what is considered force majeure is also heavily negotiated).

Since it is such a hotly contested issue, and a sensitive one for developers who often have more limited access to additional funds, the cost overrun issue should be addressed at the term sheet stage.
Establish Investor Approval Requirements

Another issue to address early on is the approval rights, or “major decisions,” over which the investor can exercise discretion or control. Major decisions inevitably become more detailed with development projects. There will be a push-pull between a developer who is concerned about satisfying a completion guaranty to a lender and therefore wants the flexibility to take action with limited oversight, and an investor with 90% or more of the equity in the project who wants to be involved in decisions regarding how the project is built. There will also be a desire by the developer for as much latitude as possible to incur costs, adjust the budget and schedule, and otherwise deal with contractors in order to complete the project in a timely manner.

Consider Default Remedies

In development ventures, investors and developers spend considerable time discussing and negotiating the ability of the investor to remove the developer as manager of the venture if the manager is in material default under the venture agreement or fails to meet certain performance standards, in order to protect the investor’s investment. However, investors should consider that removal of a developer mid-stream might not be beneficial. Investor will have to provide substitute guarantees to a construction lender, and may not have the capability or the capacity to deal with contractors, lenders, etc. in order to complete the project. Investors should consider penalties for default other than removal (such as the right to offset losses against distributions and dilution of the developer’s interest in the venture), or otherwise establish relationship with developers who might be willing to take over a project for a fee.

Limit Sale Rights

Most developers earn a “promote,” or carried interest, as compensation for a successful development after all investor capital and a return thereon have been paid to the investor. Therefore, most developers will look to liquidate a development project as soon as possible after stabilization in order to earn that promote. For investors with a long-term hold strategy, selling the project after stabilization may not be desirable. Therefore the investor should consider whether to allow the developer to put its interest to the investor, force a sale to a third party subject to an investor right of first offer, or stay in the deal with the promote being “crystalized” and paid by the investor to the developer in cash (and the developer otherwise leaves its capital in the project until sale).

Monitor Affiliated Transactions

Developers often have affiliated companies that perform specific services such as construction management, development management and property management, and
the joint venture agreement should accurately reflect the expectation of the parties with respect to the developer’s ability to enter into contracts with its affiliates to perform these services. Since developers often receive acquisition fees, asset management fees, construction/development management fees and disposition fees through the venture in addition to any fees payable to the developer affiliates, it is critical to clearly describe the fees in the venture agreement. At a minimum, the investor should have approval rights with respect to the form of the services agreement or there should be a pre-approved form negotiated in conjunction with the venture agreement, and if not set forth in any approved form of services agreement, the venture agreement should mandate that the compensation be consistent with market rates for such services or otherwise expressly approved by the investor. The investor will want the service agreement to provide that it may be terminated without cause at any time that the developer partner ceases to be the managing member of the venture. The investor may also want to require each affiliate to be subject to the same standard of care as the developer is under the venture agreement.

Conclusion

The above sets forth a sampling of issues that could arise when entering into a joint venture with a developer. It would be difficult to summarize all potential pitfalls, but these are some of the most prevalent complications as well as the strategies that an investor may employ when confronted with these challenges. The fate of the relationship of a developer and investor does not need to be written in the stars, but rather the parties should take the time at the beginning of their relationship to carefully draft an agreement that anticipates the possible complexities down the road and clearly delineates the parties’ respective rights and obligations with respect to the venture.

Andrea Saunders Rifenbark and Elizabeth A. Willes are partners at Cox, Castle & Nicholson, LLP, a full-service law firm focused on real estate in the United States. They both specialize in advising institutional investors on joint ventures and other complex real estate transactions. Cox, Castle & Nicholson LLP is not engaged in rendering legal or tax counseling through this publication. No statement in this column is to be construed as legal, tax or investment advice.

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Selected Developments:

*Estate of Sommers v. Commissioner, 149 T.C. No. 8 (August 22, 2017)*

CCA 201745012 (Nov. 9, 2017)

PLRs 201730012, 201730017, and 201730018 (July 28, 2017)
Are you sure your net gift is not a net net gift? Should it be?

The Sommers was a case involving a “net gift” transaction, which nearly became a net net gift due to operation of state estate tax apportionment law. The case also involved the taxpayer's argument that the gift tax paid was deductible on the federal estate tax return, and two distinct marital deduction issues, one of which related to the inclusion in the gross estate under § 2035 of the gift tax paid when the decedent died within three years of making the gift.

In 2001, the decedent (who was then divorced from the wife he later re-married) sought legal advice on how to transfer works from his art collection to his three nieces, who were then his closest living relatives. His attorneys offered two proposals to reduce or eliminate gift tax on the gift of the artwork. First, they recommended that decedent transfer the artwork to a newly formed limited liability company and then make gifts of the units representing ownership interests in the entity to the nieces. This recommendation assumed that, as a result of applicable valuation discounts, the appraised value of the units in the limited liability company would be less than the value of the artwork they represented. The attorneys also recommended that the decedent make the intended gifts in two stages, transferring some units to each niece on or before December 31, 2001, and the rest thereafter. Spreading the gifts across the end of the year would increase the portions of the gifts that could be covered by the gift tax annual exclusion and also allow the decedent to use the increased applicable exclusion amount of $1,000,000 that was scheduled to take effect in 2002. Decedent wanted to transfer the maximum number of units possible to the nieces without incurring gift tax in 2001 and then complete the gifts of the units in 2002.

In accordance with the plan, decedent transferred the artwork to Sommers Art Investors, LLC and executed two sets of gift and acceptance agreements with his nieces, the first dated December 27, 2001 and the second dated January 4, 2002. When decedent and his nieces initially executed the agreements, they left blanks for the number of units for each transfer, pending completion of an appraisal of the artwork. The appraisal, completed in March 2002, assigned a value to the artwork that led decedent’s attorneys to conclude that dividing the transfers of the units between 2001 and 2002 would not allow for the complete avoidance of gift tax.

After the nieces agreed to pay any gift tax resulting from the 2002 transfers, the gift and acceptance agreements were completed by filling in the blanks for the numbered units covered by each transfer. Decedent and his nieces amended each of the 2002 agreements to add a provision in which each donee-niece “agreed to pay the gift taxes, if any, relating to the gift of the units, including, without limitation, any gift taxes, penalties, and interest that may later correctly be assessed.”
federal estate tax liability resulting from the gifts, but none of them specifically exculpated the donees from other liabilities.

In June 2002, shortly before remarrying his ex-wife, decedent initiated litigation in Indiana against his nieces challenging the validity of the purported gifts and seeking return of the artwork. The litigation in Indiana and similar litigation initiated by his wife in New Jersey after decedent’s death on November 1, 2002 ultimately upheld the validity of the gifts.

In an earlier case, Estate of Sommers v. Commissioner, T.C. Memo. 2013-8 (January 10, 2013), the Tax Court also upheld the validity of the gifts. The surviving spouse had initiated that case as well, seeking a ruling that the gifts were not valid; therefore the inclusion of the artwork in the decedent’s gross estate would result in the entire estate due on them being apportioned to the nieces under the New Jersey estate tax apportionment statute. The Tax Court ruled that the gifts were completed, but denied the motion for summary judgment on the estate tax apportionment issue, stating that the parties at that stage had not adequately briefed the issue. After the ruling in the prior Sommers case, the parties stipulated that the 2002 gift tax liability for the second tranche of LLC transfers to the nieces was $273,990. After the entry of that stipulation, in accordance with the agreements governing their gifts from decedent, the three nieces paid the gift tax due on the 2002 gifts.

In April 2002, decedent executed his will that directed his executor “to pay all of … [his] just debts … including funeral and burial costs, and expenses of … [his] last illness, and all costs and expenses of administering and settling … [his] estate.” The will gave everything left after payment of those debts to decedent’s surviving spouse. This provision in the will did not mention taxes.

Decedent died in November 2002. Decedent’s wife succeeded to the property she owned jointly with decedent, received other property pursuant to beneficiary designations, and would have received all assets remaining in decedent’s estate remaining after the payment of debts and expenses.

On the decedent’s federal estate tax return, the executor (the surviving spouse) included assets totaling $1,734,476.29 that were either held in joint tenancy or tenancy by the entireties with the surviving spouse, or given to the surviving spouse directly through beneficiary designations. The estate also included “other miscellaneous property” of $59,494 and “lifetime transfers” of $507.34. The estate tax return included a potential claim of $200,000 against a trust of which the decedent was a beneficiary and co-trustee, and the artwork which had been given to the nieces. On the return, the decedent’s estate took deductions for legal and accounting fees, other administration expenses, and debts of $413,459.86, and a marital deduction of $3,330,510.43. All of this left the decedent with a taxable estate, as reflected on the return, of $507.34:
Joint Property and Beneficiary Designations to Surviving Spouse $1,734,476.29
Other miscellaneous property 59,494.00
Lifetime transfers 507.34
Potential claim against trust of which decedent was beneficiary and cotrustee 200,000.00
Artwork 1,750,000.00
Gross estate 3,744,477.63
Legal and accounting fees ($310,000.00)
Other expenses (14,513.39)
Debts (88,946.47) (413,459.86)
Marital deduction (3,330,510.43)
Taxable estate 507.34

The IRS, upon examination, but before the stipulation was entered in the prior Sommers decision on the gift tax liability, made three adjustments that increased decedent’s taxable estate from $507.34 to $1,092,106.68 and resulted in estate tax due of $542,593.34: it included under 2035(b) its original assessment of gift tax due in the amount of $510,648; excluded from the gross estate the $1,750,000 value of the artwork included on the return; and reduced the allowable marital deduction by $2,330,951.34. The reduction in the marital deduction (by more than the $1,750,000 removed from the gross estate) reflected the IRS determination that the estate tax due on the 2035(b) inclusion of the gift tax due would have to be paid out of marital assets.

The IRS, after the stipulation as to the amount of gift tax owed on the 2002 gifts in the prior Sommers case, determined estate tax of $220,726 on a taxable estate of $494,716.65. The $200,000 potential claim listed on the original return was removed from the gross estate, and the deduction allowed for decedent’s debts was increased by $105,928.35 (the interest on the gift tax liability). The estate tax deficiency of $220,726 reduced the marital deduction that the IRS would allow to $1,054,362.77. Thus, when this second Sommers case went to the Tax Court, the estate was as follows:
<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint Property and Beneficiary</td>
<td>$1,734,476.29</td>
</tr>
<tr>
<td>Designations to Surviving Spouse</td>
<td>$59,494.00</td>
</tr>
<tr>
<td>Other miscellaneous property</td>
<td>507.34</td>
</tr>
<tr>
<td>Lifetime transfers</td>
<td>507.34</td>
</tr>
<tr>
<td>§ 2035(b) Gift Taxes</td>
<td>273,990.00</td>
</tr>
<tr>
<td>Gross estate</td>
<td>2,068,467.63</td>
</tr>
<tr>
<td>Legal and accounting fees</td>
<td>($310,000.00)</td>
</tr>
<tr>
<td>Other expenses</td>
<td>(14,513.39)</td>
</tr>
<tr>
<td>Debts</td>
<td>(194,874.82)</td>
</tr>
<tr>
<td>Marital deduction</td>
<td>(1,054,362.77)</td>
</tr>
<tr>
<td>Taxable estate</td>
<td>$494,716.65</td>
</tr>
</tbody>
</table>

The estate filed three motions for partial summary judgment seeking determinations that:

(1) The gift tax owed at decedent’s death on his gifts to nieces was deductible under Section 2053;

(2) The estate was entitled to a marital deduction equal to the value of decedent’s non probate property that the wife received or to which she succeeded that, under applicable state law, was exempt from decedent’s debts and the expenses of the estate; and

(3) Any federal estate tax due must be apportioned to the nieces and thus did not reduce the estate’s marital deduction.

The three nieces filed their own motion for partial summary judgment that none of the estate tax liability could be apportioned to them. The nieces supported the estate’s first two motions. The IRS objected to the estate’s first two motions but supported the third motion (that federal estate taxes should be apportioned to the nieces). Thus, both the estate and the IRS opposed the niece’s motion for summary judgment.

**Deduction for Gift Taxes Paid After Death**

The estate moved for summary judgment that the gift tax owed at decedent’s death on his gifts to nieces was deductible under Section 2053. Treas. Reg. § 20.2053-6(d) provides that “[u]npaid gift taxes on gifts made by a decedent before his death are deductible.” The decedent’s estate argued that the plain terms of that provision allowed a deduction for the gift tax owed on the 2002 gifts and unpaid at his death.

When a net gift is made, the full value of the property transferred by the donor to the donee is not treated as a taxable gift. Instead, the taxable gift, determined algebraically, is the difference between the total value of the property transferred and the gift tax on the “net” gift. Despite the allowance of
a deduction for gift taxes “unpaid” as of the decedent’s death under Treas. Reg. § 20.2053-6(d), the court found that the “key question” was not whether the decedent or his estate served as the ultimate source of funds for the gift tax, but when the decedent parted with the value.

Here, decedent effectively provided the nieces with the wherewithal to pay tax on the taxable gifts because for each niece, a portion of the units transferred in 2002 was ultimately determined to be a taxable gift, while another portion was determined to be the value necessary to pay the gift tax with respect to the net gift. Therefore, because the decedent made the transfers to the nieces before he died, he reduced his gross estate by not only the value of the taxable gifts but also the by the amount of the tax on the gifts.

In addition, the court noted that longstanding precedent established that a claim against an estate is deductible in computing the estate tax liability only to the extent that it exceeds any right to reimbursement to which its payment would give rise, and that this principal required denying to the estate any deduction for the gift tax owed at the decedent’s death on his 2002 gifts to his nieces. Even if the estate had paid the gift tax after the decedent’s death, it would have had a right to reimbursement from the nieces pursuant to the net gift agreements.

The court wrote that the “gross-up” rule of § 2035 was included in the Tax Reform Act of 1976 to “deter taxpayers from making gifts shortly before death to exclude from their estate (and avoid transfer tax on) the property used to pay the transfer tax.” The court found that allowing a deduction in this case would allow the excess of the “gross transfer” over the “net gifts” to escape transfer tax altogether. Inclusion of the gift tax in decedent’s estate did not justify allowing a deduction for gift tax paid in this case any more than in a case of a gross gift for which the decedent paid the gift tax before the decedent died. Indeed, the estate “acknowledge[d] that the deduction [it sought] would neutralize the impact of section 2035(b).”

For example, if a gross gift of $7,142,858 is made, the gift tax liability would be $2,857,142. If the donor dies within three years of making the gift but had paid the gift tax prior to death, that amount would have be removed from the gross estate, no deduction would be allowed under Treas. Reg. § 20.2053-6(d), and the estate would include the $2,857,142 gift tax liability in the gross estate under § 2053(b).

However, if the gift tax was not in fact paid by the donor prior to his or her death, the gift tax of $2,857,142 would be included in the gross estate under § 2053(b), and that amount would also remain in the donor’s gross estate. In that case, the deduction allowable under Treas. Reg. § 20.2053-6(d) for the gift tax paid after death is appropriate to avoid double-counting the amount of the gift tax.
If a net gift (a “gross transfer”) of $10,000,000 is made, the donor has “withdraw[n] from his potential estate not only the value of the taxable gifts but also the amount of the tax on the gifts.” Even if the gift tax is paid after the donor’s death (by the donees), no deduction is allowed. The gift tax liability of $2,857,142 is included in the estate only once, under § 2053(b).

Marital Deduction Reduced Due to Payment of Debts and Expenses

The court also denied the estate’s motion for partial summary judgment regarding the effect of the payment of debts and claims on the marital deduction because the amount of the allowable deduction turned on the factual question of the extent to which assets otherwise exempt from claims against the estate were used to pay estate debts and expenses, and when those debts and expenses were paid.

Section 2056(a) allows a deduction for the “value of any interest in property which passes or has passed from the decedent to the surviving spouse.” Treas. Reg. § 20.2056(b)-4(a) provides that value for that purpose means net value. Consequently, when property that would otherwise have been distributed to surviving spouse is used to satisfy debts of the estate, it is not included in the allowable marital deduction. The court stated, “[e]ven when marital assets would otherwise be exempt from debts and expenses under State law or the terms of the decedent’s will, executors may be forced to sell those assets to satisfy debts and or pay expenses if nonmarital assets are insufficient.” In addition, “[f]or purposes of determining the marital deduction, the value of the marital share shall be reduced by the amount of the estate transmission expenses paid from the marital share.” Treas. Reg. § 20.2056-4(d)(1)(ii).

The deduction allowed to an estate under section 2053(a) for expenses and claims generally cannot “exceed the value, at the time of the decedent’s death, of property subject to claims,” but claims and expenses paid from property not subject to claims are nonetheless deductible if they are paid before the due date of the estate tax return. § 2053(c)(2). Note that if expenses are incurred in administering the property not subject to claims, those expenses are deductible so long as they are paid before the expiration of the period of limitation for assessment of the estate tax return. § 2053(b).

As described above, the assets of the estate other than assets passing directly to the surviving spouse as surviving joint tenant or by beneficiary designation totaled $59,494.00. However, the estate claimed deductions on the estate tax return of $413,459.86 for fees, expenses, and debts.

The court wrote that the “excess” amount of debts and expenses “would be fully deductible only if [they] were voluntarily paid before the due date of the estate tax return out of assets that were exempt from claims against the estate.” Although not specifically stated, the court must have been operating
under the belief that none of the expenses were “incurred in administering property not subject to claims.” See § 2053(b). The court held that either the allowable marital deduction must be reduced by the amount of the decedent’s fees, expenses, and debts paid from property otherwise passing to the surviving spouse, or the estate is not entitled to deduct in full the debts and expenses reported on the estate tax return. The factual questions of the extent to which assets otherwise exempt were used to pay debts and expenses and when they were paid precluded the court’s re-determination of the actual amount of the allowable marital deduction.

Marital Deduction Reduced by Estate Tax Incurred on Gift Tax Inclusion

On the question of whether the federal estate tax due reduced the estate’s marital deduction, the court devoted over eleven pages of this Tax Court opinion to state law on estate tax apportionment. This case turned on interpretation of the New Jersey estate tax apportionment statute, the relevant parts of which provide as follows:

Whenever a fiduciary has paid or may be required to pay an estate tax under any law of the State of New Jersey or of the United States upon or with respect to any property required to be included in the gross tax estate of a decedent under the provisions of any law, hereinafter called “the tax,” the amount of the tax … shall be apportioned among the fiduciary and each of the transferees interested in the gross tax estate …, and the transferees shall each contribute to the tax the amounts apportioned against them. N.J.S.A. 3B:24-2.

“Gross tax estate” means all property of every description required to be included in computing the tax. N.J.S.A. 3B:24-1.b.

“Transferee” means any person to whom the gross tax estate or any part thereof is, or may be, transferred or to whom any benefit therein accrues other than that part of the gross tax estate which passes under the will of decedent…. N.J.S.A. 3B:24-1.c.

That part of the tax shall be apportioned to each of the transferees as bears the same ratio to the total tax as the ratio which each of the transferees’ property included in the gross tax estate bears to the total property entering into the net estate for purposes of that tax…. N.J.S.A. 3B:24-4.a.

Any deduction allowed under the law imposing the tax by reason of the relationship of any transferee to the decedent or by reason of the charitable purposes of the gift shall inure to the benefit of the fiduciary or transferee, as the case may be…. N.J.S.A. 3B:24-4.b.

The court noted that the New Jersey estate tax apportionment statute was enacted in 1950, and “did not explicitly address the possibility that the value
of property not includible in the decedent’s gross estate could nonetheless influence the amount of estate tax liability. When those statutes were first enacted, that possibility did not arise, at least under the Federal estate tax law.” Prior to 1976, “lifetime gifts made by a decedent could affect his Federal estate tax liability only if made in contemplation of death, in which case the transferred property was included in the decedent's gross estate.” The court wrote that “[t]he New Jersey courts have yet to address the extent to which their State’s statute provides for apportionment of estate tax to recipients of lifetime gifts.”

The estate argued that the decedent’s gifts were part of his “gross tax estate” within the meaning of the New Jersey apportionment statute. The estate also argued that a portion of the property the nieces received “represent[ed] the gift tax that was added back to [decedent's] estate.”

The IRS agreed that “the estate tax is apportioned to [the nieces] under New Jersey law, [so that] the estate tax does not reduce the marital share.” The IRS reasoned that the nieces were “transferees” within the meaning of the New Jersey statute, because they “are persons to whom a benefit in the gross tax estate accrues.”

The nieces argued that “Gift Tax Clawbacks are not ‘transferees' property' [sic] within the meaning of the Apportionment Statute,” and that apportioning any of the estate tax liability to them would be inconsistent with decedent’s intent. The intent, they argued, was displayed in the net gift agreement, under which the only liability the nieces agreed to bear was the gift tax.

The court found that under the New Jersey’s estate tax apportionment statute, no portion of any estate tax could be apportioned to the three nieces. Even though the definition of “gross tax estate” means all property “required to be included in computing the tax,” the court explained that “both the structure of the apportionment scheme as a whole and the history of the specific provision defining ‘gross tax estate’ suggest that the New Jersey legislature intended the phrase ‘included in’ to limit the gross tax estate to property encompassed within the base to which the tax applies.” Further, “[a]lthough adjusted taxable gifts, together with the taxable estate, form the base on which the ‘tentative tax’ provided for in sec. 2001(b)(1) is computed, that tax is reduced by a hypothetical tax on post-1976 gifts. The inclusion of adjusted taxable gifts in the base to which the tentative tax applies thus serves only to push the taxable estate further up the marginal rate scale.”

Because the LLC units the nieces received from their uncle were not included in computing the decedent’s federal estate tax liability under the New Jersey apportionment statute, the nieces were not “transferees” against whom any of the estate tax liability could be apportioned for purposes of the New Jersey apportionment statute.
In addressing the estate’s second argument, which rested on “the unique circumstances of a ‘net’ gift,” the court found that “no portion of the units decedent transferred to [the nieces] was included, as such, in his gross estate.” While the general rules provide that the gross estate includes “the value of specified items of property,” section 2035(b) “speaks instead of amounts: ‘The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid … on any gift made by the decedent … during the 3-year period ending on the date of the decedent’s death.’” Thus, the nieces were not persons “to whom the gross tax estate, or any part thereof” was “transferred,” and thus were not “transferees” within the meaning of the New Jersey statute.

The court went on to discuss whether the payment of the estate tax would reduce the marital deduction claimed by the estate, with respect to which the estate had argued, “New Jersey law does not permit apportionment of the tax to a surviving spouse’s share of an estate, and so under no circumstances may the marital deduction be reduced for any estate tax.”

While the New Jersey statute requires that total estate tax be apportioned in a manner that preserves for the benefit of decedent’s spouse, to the extent possible, the benefit of any marital deduction, the statute “does not provide absolute protection to a surviving spouse against bearing the economic burden of a tax imposed on the decedent’s estate.” “[T]o the extent that property that would otherwise have been distributed to the spouse must be used to pay the tax, it would not be covered by the marital deduction allowed by section 2056(a).” If neither the estate nor the nieces were “transferees” subject to the apportionment statute, the federal estate tax liability would be apportioned entirely to the estate.

That statute provided insufficient grounds to rule that as a matter of law any estate tax due could not affect the allowable marital deduction. The court concluded that the existing record did not allow for the court to determine the extent to which the estate tax would reduce the value of the marital share of the decedent’s estate. Tax apportioned to the fiduciary could reduce residuary distributions to the surviving spouse. If the surviving spouse pays estate tax out of assets that would otherwise have been used to pay debts or expenses, the tax would not reduce the value of the property ultimately received by the surviving spouse and would be borne by the estate’s creditors.

The court concluded this issue with the following: “[T]he ultimate incidence of that portion of tax might depend on the vagaries of the Service’s exercise of discretion in choosing among alternative sources for the tax’s collection. Whoever pays that portion of the estate tax would presumably have a right to reimbursement from a fiduciary with no assets remaining under his control from which to make the required reimbursement. We need not address those potential conundrums at this juncture.”
Notably, however, the court compared the New Jersey apportionment statute to statutes and common law from other jurisdictions, and appeared to conclude that under some state laws, estate taxes owed on the gift tax component of a net gift could be apportioned to the lifetime donees.

“In a few jurisdictions in which legislators did not update their State’s apportionment statutes to reflect the 1976 changes in the Federal transfer tax regime, courts have approved apportionment of estate tax to recipients of lifetime gifts, without clear statutory mandate, apparently to remedy perceived inequities.” The court cited the cases *Bunting v. Bunting*, 760 A.2d 989 (Conn. App. Ct. 2000); *Shepter v. Johns Hopkins Univ.*, 637 A.2d 1223 (Md. 1993); and *In re Estate of Necaise*, 915 So. 2d 449 (Miss. 2005), in each of which the court approved such apportionment. Further, the court noted that the apportionment statutes in each of those states “under statutes modeled on the 1964 Uniform Act that, if anything, provide even less textual basis for such apportionment than the New Jersey statute does.”


The New York statute provides that any estate tax “with respect to property required to be included in the gross tax estate of a decedent…shall be equitably apportioned among the persons interested in the gross tax estate,” EPTL § 2-1.8, but does not define “gross tax estate.” The court in *Coven* declined to apportion estate taxes to lifetime transfers because “adjusted taxable gifts are added to the tax calculation … in a separate step after the taxable estate has been determined.” However, the court in *Coven* had “no doubt” that “an inequity [had been] caused by the gross-up of the estate into a higher tax bracket as a result of the lifetime gifts. *Estate of Coven*, 559 N.Y.S.2d at 800. The court in *Sommers* pointed out that even though the gifts in *Coven* were made less than three years before the decedent’s death, “the issue of apportionment of the estate tax on any [§ 2035(b)] inclusion was not before the court.”

The court in *Metzler* reached the same conclusion as the court in *Coven*, and also noted the potential inequity: “Although it might appear that it would be more equitable to apportion the estate tax against all assets causing the tax, EPTL 2-1.9 does not authorize such apportionment.” The *Metzler* case went on, however, to write that the failure to apportion estate tax to the recipients of lifetime gifts may not have been inequitable because, “[i]n making the interivos gifts to petitioner, the decedent implicitly intended that petition take those gifts free of any tax obligation.” *Metzler*, 579 N.Y.S. at 289. Like *Coven*, the *Metzler* case involved gifts made within three years of death, but like *Coven*, the *Metzler* case did not address the gift tax that would have been included in the gross estate under § 2035(c) even though the transferred property would not have been.
The apportionment statutes of Connecticut, Maryland, and Mississippi were modeled after the 1964 Uniform Estate Tax Apportionment Act. The Connecticut statute provides as follows:

[T]he amount of the tax [paid upon or with respect to any property required to be included in the gross estate of a decedent], except when a testator otherwise directs in his will or when, by written instrument executed inter vivos, direction is given for apportionment within the fund of taxes assessed upon the specific fund dealt with in such inter vivos instrument, shall … be equitably prorated among the persons interested in the estate to whom such property is or may be transferred or to whom any benefit accrues. C.G.S.A. § 12-401(a).

The Mississippi statute provides as follows:


“Person interested in the estate” means any person including an executor, administrator, guardian, conservator or trustee, entitled to receive, or who has received, from a decedent while alive or by reason of the death of a decedent any property or interest therein included in the decedent’s taxable estate. Miss. Code Ann. § 27-10-5.

If the chancery court finds that it is inequitable to apportion interest and penalties in the manner provided in this chapter because of special circumstances, it may direct apportionment thereon in the manner it finds equitable. Miss. Code Ann. § 27-10-9(2).

And the Maryland statute provides as follows:

The tax “shall be apportioned among all persons interested in the estate.” MD Code § 7-308(b)(1)

“Person interested in the estate” means any person who is entitled to receive or has received, from a decedent while alive or by reason of the death of a decedent, any property or interest in property included in the taxable estate of the decedent. MD Code § 7-308(a)(4)

If the court finds that it is inequitable to apportion interest and penalties as provided in this section because of special circumstances, the court may direct apportionment in the manner that it finds equitable. MD Code § 7-308(c)(2).

The Connecticut court in Bunting apportioned estate tax to lifetime gifts notwithstanding the following provision in the decedent’s will (which was executed after the lifetime gift): “I direct that any estate, succession, inheritance, death or transfer tax arising by reason of or in any way in connection with my death, be paid out of my estate as an expense of
administration thereof, without apportionment or contribution.” The court found a latent ambiguity in the will due to the substantial lifetime gift, and wrote, “[a]lthough a gift tax return was filed, in which over two thirds of the decedent’s unified estate and gift tax credit was used to avoid payment of tax on the gift at that time, testimony at trial indicated that, at the time of the gift, the decedent’s attorney did not believe that the gift was taxable. Accordingly, there was no discussion concerning how taxes on the decedent’s estate would be allocated in view of this rather large gift.” Bunting, 760 A.2d at 993-94.

In the Mississippi case, Necaise, the decedent’s will provided as follows:

Each bequest under my Will, whether such bequest is specific or residual, shall be charged with the payment of its proportionate part of Mississippi and federal estate taxes payable by reason of my death including interest and penalties thereon as provided for under Mississippi Code Ann. § 27–10–1, et seq., except that in allocating the taxes among the beneficiaries, any lifetime gift made by me ... to a beneficiary, including my son RUSSELL RAYMOND NECAISE, JR., which would be an adjusted taxable gift on my estate tax return ... [,] shall be taken into account and treated as if such gift ... is a part of the bequest to such beneficiary under this Will.

Necaise, 915 So.2d at 451. Thus the decedent’s will effectively contained a direction to apportion estate taxes to lifetime gifts. However, the court in Necaise also wrote, “Clearly, Raymond meets the definition of “person interested in the estate” as provided in Miss.Code Ann. § 27–10–5(d).”

In Shepter the donee of the lifetime gift argued that the Maryland statute did not provide for apportionment of estate tax to him “because, under amendments to the IRC made by Congress after Maryland adopted the Uniform Act, the transfer to him is not treated as part of the ‘taxable estate’ … but it is reported on the return as an ‘adjusted taxable gift’. ” The Maryland court responded:

Following [the 1976] change in the IRC, the National Conference of Commissioners on Uniform State Laws saw no need to amend the Uniform Act to address the change, and the General Assembly has not done so. Nevertheless, apportionments continue to be made of the total estate tax imposed by IRC § 2001. This practical contemporaneous construction, that has existed for seventeen years, reflects that … the tax imposed by IRC § 2001 … [is] computed by including values reported on the return as “adjusted taxable gifts” per IRC § 2001(b)(1)(B).”

The Shepter case involved a gift made within three years of death, so again, although the transferred property would not have been included in the
decendent’s taxable estate, the gift tax on that gift would have been son included under § 2035(b).

After the Shepter decision, the Maryland legislature adopted a law that repealed and reenacted without amendment Md. Code Ann., Tax–Gen. secs. 7–308(a)(1) and (4), the purpose of which was “confirming that apportionment of a decedent's federal and Maryland taxes is not to be made to interests not included in the decedent's taxable estate for federal estate purposes notwithstanding a certain case holding; confirming that an apportionment of a decedent's federal or Maryland estate taxes may not be made to gifts not included in the decedent's federal taxable estate…” 1995 Md. Laws 3218, 3219.

That Maryland law, while not amending the statutory provisions at all, also provided that the references in the statute to “taxable estate,” “interest,” and “interests” “do not include any interest of the decedent that is not included in the value of the decedent's taxable estate determined under §§ 2001(b)(1)(A) and 2051 of the Internal Revenue Code of 1986, and specifically do not include any adjusted taxable gifts of the decedent as defined in § 2001(b) of the Internal Revenue Code, notwithstanding any holding or dictum to the contrary in Shepter v. Johns Hopkins University, 334 Md. 82, 637 A.2d, 1223 (1994).” The law also provided that “apportionment of a decedent's federal estate tax may not be made … to any adjusted taxable gift of the decedent, as defined in § 2001(b) of the Internal Revenue Code.”

Implications for Net Gifts

The Uniform Estate Tax Apportionment Act had not been amended after the 1976 change to the federal estate tax law until 2003. The 2003 Uniform Act defines “Apportionable estate as “the value of the gross estate as finally determined for purposes of the estate to be apportioned reduced by … any amount added to the decedent’s gross estate because of a gift tax on transfers made before death.”

The New York courts in Coven and Metzler addressed cases involving gifts made within three years of death. While both courts declined to apportion estate taxes to the lifetime gifts, neither court addressed the inclusion in the gross estate of gift tax paid under § 2035(b).

The Connecticut and Mississippi cases, Bunting and Necaise, respectively, interpreted statutes in a way that resulted in apportionment of estate taxes to donees of lifetime gifts. The Connecticut apportionment statute applies to property “included in the gross estate,” and the Mississippi statute applies to property “included in the taxable estate.” Neither case involved a gift made within three years of death. But, if the courts were willing to apply this language to adjusted taxable gifts (which are not included in the gross estate or taxable estate), why would they not apply the statutes to gift taxes on gifts
made within three years of death, which are included in the gross estate and the taxable estate?

The Shepter case in Maryland did involve a gift made within three years of death, but section 2035 was not even mentioned in the opinion. Even after the action of the Maryland legislature, a Maryland court may treat gift tax included in the federal taxable estate differently than adjusted taxable gifts themselves, which are not included in the federal taxable estate. The Maryland law passed in 1995 referred to “items not included in the value of the decedent’s taxable estate determined under §§ 2001(b)(1)(A) and 2051” and specifically referred to “adjusted taxable gifts.” Gift taxes included under § 2035(b) are included in the federal taxable estate are not “adjusted taxable gifts,” and are included in the taxable estate determined under § 2001(b)(1)(A).

Further, both the Maryland and Mississippi statutes directly provide that the court may deviate from the statutory apportionment scheme if it “finds that it is inequitable to apportion interest and penalties as provided,” in which case it may “direct apportionment in the manner that it finds equitable.” The Connecticut statute provides that estate taxes shall be “equitably prorated.” The New Jersey statute contains no such provision!

The 2003 Uniform Act omits any reference to a court’s power to “remedy perceived inequities” by deviating from the statutory scheme. Under the 2003 Uniform Act, the only circumstance under which the recipient of a lifetime gift could be required to pay estate tax is when any estate tax due “cannot be collected from [a] person” from whom it is due, and only then after all other assets in the “apportionable estate have been exhausted.” However, many state apportionment statutes, including the five described above, have not been amended since the 2003 Uniform Act. Some states (like my home state of Illinois) do not even have estate tax apportionment statutes.

A glaring solution to this should be to provide for the apportionment of estate taxes in express terms in the estate planning documents, but see the provision in the decedent’s will in Bunting, which the court held was subject to a latent ambiguity.

Portions of materials from the 2015 RPTE Spring Symposia presentation on the Steinberg case and net net gifts (by this author and Tiffany Carmona) are appended to this outline. If estate tax resulting from the inclusion under § 2035(b) of gift tax paid on a gift made within three years of death is apportioned to the donee of the gift, is the gift then a net net gift even without an express agreement to that effect? Should the value of the gift be reduced by the estate tax liability placed on the donee of the gift (and an amended Form 709 filed)? And by that point, the fact of death within three years of the gift is known, so does that change the actuarial computation of the net net gift amount? In states where the statute has been held to apportion estate taxes to lifetime gifts, can the donor treat that burden of estate tax on the donee as
consideration that reduces the value of the gift? One concern raised regarding net net gifts was the possibility that the assumption by the donee of the § 2035(b) estate tax liability would, itself, be considered a separate assets includible in the gross estate. Would that apply if the donor and donee “acknowledge” that any estate taxes incurred due to § 2035(b) inclusion will be apportioned to the donee under state law? Finally, would the net net gift be a better result if all assets remaining in the gross estate would otherwise qualify for a marital deduction?

CCA 201745012 (Nov. 9, 2017)

Purchase of GRAT remainder by grantor is held not to be for adequate consideration for either gift tax or estate tax purposes.

On Date 1, Donor formed Trust 1, an irrevocable discretionary trust for the benefit of Donor’s first spouse and issue. Trust 1 terminates on the later of the death of Donor or his first spouse, at which time the principal and any accumulated income are distributed outright to Donor’s issue per stirpes. Donor’s first spouse predeceased him; Donor then married Spouse.

On Date 2, Donor formed Trust 2, an irrevocable trust – a GRAT – for the benefit of Donor and his issue. Under the terms of Trust 2, an annuity is payable to Donor for the term of the trust, and the remainder is payable under the terms of Trust 1.

On Date 3, Donor formed Trust 3, a GRAT for the benefit of Donor and his issue. Under the terms of Trust 3, an annuity is payable to Donor for the term of the trust, and the remainder is payable under the terms of Trust 1.

On Date 4, a date before the expiration of the annuity terms of Trusts 2 and 3, Donor bought the remainder interests in Trusts 2 and 3 from the trustees of Trust 1. Donor paid the purchase price with two unsecured promissory notes. Donor died the following day (before the annuity terms of Trusts 2 and 3 expired).

Donor’s executor filed a gift tax return and reported the purchases of the remainder interests as non-gift transfers, asserting that Donor received adequate and full consideration in money or money’s worth in the form of the remainder interests in Trusts 2 and 3. Spouse elected to split gifts with Donor.

Donor’s executor filed an estate tax return, and included the corpus of Trusts 2 and 3 in the gross estate. Donor’s executor deducted the value of the outstanding promissory notes payable to the trustees of Trust 1 as claims against the estate.

The IRS analyzed two issues: whether adequate consideration was provided by Donor for the GRAT remainder interests, and whether the notes were properly deductible on the estate tax return (also an “adequate consideration” issue, but under § 2053(c)(1)(A)).
Adequate Consideration. The Chief Counsel’s Office relied on Commissioner v. Wemyss, 324 U.S. 303 (1945) and Merrill v. Fahs, 324 U.S. 308 (1945), in which the Supreme Court held that “adequate and full consideration in money or money’s worth” has a different meaning for contracts law purposes than it does for gift tax purposes. The gift tax law requires consideration that is reducible to a money value and thereby replenishes the recipient’s estate for the value of the property for which it was transferred. The right to decide how property shall be disposed of may have value for contract law purposes, but it does not replenish the transferor’s estate and thus does not constitute adequate and full consideration for gift tax purposes.

Here, Donor’s liability on the promissory notes depleted his taxable estate. However, the Chief Counsel’s Office wrote, “in the context of a deathbed purchase of a remainder interest in transferred property in which a donor has retained a § 2036 ‘string,’ the receipt of the remainder does not increase the value of the donor’s taxable estate, because the value of the entire property, including that of the remainder, will be includible in the donor’s gross estate pursuant to § 2036(a)(1).” Thus, the Donor’s receipt of the remainder interests cannot constitute adequate and full consideration in money or money’s worth for gift tax purposes.

Deductibility of the Notes. Section 2053(c)(1)(A) provides, in part, that the deduction allowed in the case of claims against the estate, unpaid mortgages, or any indebtedness shall, when founded on a promise or agreement, be limited to the extent that they were contracted bona fide and for an adequate and full consideration in money or money’s worth. Treas. Reg. § 20.2053-1(b)(2)(i) provides, in part, that amounts allowed as deductions under § 2053 must be expenses and claims that are bona fide in nature. No deduction is permissible to the extent it is founded on a transfer that is essentially donative in character (a mere cloak for a gift or bequest). Treas. Reg. § 20.2053-4(d)(5) provides in part, that the deduction for a claim founded upon a promise or agreement is limited to the extent that the promise or agreement was bona fide and in exchange for adequate and full consideration in money or money’s worth; that is, the promise or agreement must have been bargained for at arm’s length and the price must have been an adequate and full equivalent reducible to a money value. In Merrill v. Fahs, the Supreme Court held that adequate and full consideration should be deemed to have the same meaning in both the estate tax and the gift tax. 324 U.S. at 313 (1945).

The Chief Counsel’s Office concluded that the notes were not deductible as a claim against Donor’s estate: “[w]here the purchase of the remainder occurs on the donor’s deathbed while he is holding a § 2036 ‘string’ to the transferred property, the remainder does not increase the value of the donor’s taxable estate … because the entire value of the transferred property, including that of the remainder, will be includible in the donor’s gross estate pursuant to § 2036(a)(1).” For that reason, the Donor’s deathbed receipt of the remainder interests cannot constitute adequate and full consideration within the meaning
of § 2053(c)(1)(A). The CCA concluded that the “promissory notes are a mere cloak for a gift,” citing Treas. Reg. § 20.2053-1(b)(2)(i).

Note that the Chief Counsel’s Office made reference several times to the “donor’s deathbed.” Would the result be any different if the Donor survived several years but nevertheless died before the end of the GRAT term? It seems the same analysis, in which the Donor’s estate was not diminished by the purchase of the remainder interest, would apply.

PLRs 201730012, 201730017, and 201730018 (July 28, 2017)

No charitable deduction is allowed upon conversion of a nongrantor trust-CLAT to a grantor trust-CLAT.

In these PLRs, grantor had created CLATs that were nongrantor trusts. As such, the trust was previously allowed charitable deductions under § 642(c)(1) for amounts of gross income included in the annuity amounts each year. The trustee sought to amend the trust agreements pursuant to state law to permit the “substitutor” to have the power, exercisable at any time in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to acquire or reacquire trust principal by substituting other property of an equivalent value, determined as of the date of substitution.

In each PLR, the grantor requested three rulings: (1) the conversion of the CLAT from a nongrantor trust to a grantor trust (assuming the substitutor is found to hold the substitution power in a nonfiduciary capacity) is not a taxable transfer of property held by the trust to the grantor as settlor for income tax purposes; (2) the conversion of the CLAT from a nongrantor trust to a grantor trust is not an act of self-dealing that would result in a tax under § 4941; and (3) the conversion of the CLAT from a nongrantor trust to a grantor trust would result in an income tax charitable deduction for the grantor in the year of conversion under § 170.

While granting favorable rulings on the first two requests, the IRS did not allow the grantor to take a charitable deduction in the year of conversion. Rev. Proc. 2007-45 provides that a donor to a grantor CLAT may claim a federal income tax charitable deduction under § 170(a) in the year that assets are irrevocably transferred to the trust. Because the conversion of the CLAT from a nongrantor trust to a grantor trust was not a transfer of property, the grantor is not able to take an income tax charitable deduction under § 170(a).
Update on *Jimmo v. Sebelius*¹

By Heidi M. Brown, Esq.

On October 16, 2012, the parties to *Jimmo v. Sebelius* filed a proposed Settlement Agreement ("Agreement"),² which was later approved by the United States District Court for Vermont on January 24, 2013.³ This case dealt with the so called “improvement standard” and whether this standard was the proper standard for Medicare to pay for skilled nursing services or home health services. In other words, is the patient required to improve in order for Medicare to pay for these services? Or, is the patient’s need for these services to maintain their health or condition sufficient for Medicare to pay for skilled nursing services or home health services? This article will discuss the case, its Settlement Agreement, and whether the parties have complied with the Settlement Agreement.

On January 18, 2011, six Medicare beneficiaries filed a lawsuit on behalf of themselves and “[a]ll beneficiaries of Medicare Parts A, B, or C who have had or will have coverage for health care or therapy services, as an outpatient, in a hospital, in a skilled nursing facility, or in a home health care setting denied, terminated, or reduced due to the application of the Improvement Standard” (the Plaintiffs).⁴ Also among the Plaintiffs were seven national organizations such as National Committee to Preserve Social Security and Medicare, National Multiple Sclerosis Society, Parkinson’s Action Network, Paralyzed Veterans of America, American Academy of Physical Medicine and Rehabilitation, Alzheimer’s Association®, and United Cerebral Palsy.⁵ The Plaintiffs sought declaratory, injunctive, and mandamus relief against the Secretary of Health and Human Services (the Secretary), who at that time was Kathleen Sebelius.⁶

According to the Plaintiffs, “the Secretary… impose[d] a covert rule of thumb that operate[d] as an additional and illegal condition of coverage and result[ed] in the termination, reduction, or denial of coverage for thousands of Medicare beneficiaries annually,” however, the Secretary denied the existence of a “covert rule of thumb.”⁷ Specifically, this “covert rule of thumb” was called the “Improvement Standard.”⁸ For example, adjudicators of Medicare claims terminated or denied coverage for benefits and cited as the reasons, the beneficiary is “not improving” or the ‘beneficiary needs ‘maintenance services only,’” or the beneficiary has “‘plateaued, or is “chronic,” or “medically stable.””⁹ Further, the Plaintiffs argued that Medicare coverage “is available for health care and therapy services that are ‘reasonable and necessary for the diagnosis or treatment of illness or injury’”¹⁰ and that neither the Medicare statutes nor regulations list improvement as a condition of coverage.¹¹ According to the Plaintiffs, this Improvement Standard affects mostly beneficiaries with chronic conditions, who will
need nursing services and therapies more if their health deteriorates. If these beneficiaries can receive these benefits, they can “slow their disease process and ... maintain their functional ability.” Moreover, the Plaintiffs argued that the reliance of the Improvement Standard for terminations, denials, or reductions in coverage “violates the Medicare statute and regulations, the Administrative Procedure Act’s and the Medicare statute’s requirements for notice-and-comment rulemaking, the Freedom of Information Act’s requirement of publication, and the Due Process Clause of the Fifth Amendment.

The parties settled and in the Agreement they agreed that Health and Human Services (HHS) would revise certain sections of Chapters 1, 7, 8, and 15 of the Medicare Benefit Policy Manual (MBPM) in order to clarify the standards for coverage of skilled nursing facility, home health, outpatient therapy benefits and inpatient rehabilitation when a beneficiary “has no restoration or improvement potential” but yet still needs these services. This was to be referred to as the “maintenance coverage standard.” If the beneficiary does not have a “clinical condition [that] demonstrates that the specialized judgment, knowledge, and skills of a qualified therapist are necessary,” then Medicare will still deny these services. Similarly, if the beneficiary is in a skilled nursing facility, these services will be covered if the beneficiary needs the services that require the skills of a registered nurse, and “would be covered where such skilled nursing services are necessary to maintain the [beneficiary’s] current condition or prevent or slow further deterioration.” If the beneficiary could perform these services himself or herself or under the supervision of unskilled caregivers, the services will not be covered. Finally, the Secretary agreed to revise the MBPM to clarify that benefits for an inpatient rehabilitation facility cannot be denied because the beneficiary “could not be expected to achieve complete independence in the domain of self-care” or “could not be expected to return to his or her prior level of functioning.”

Another section of the Settlement Agreement required the Center for Medicare and Medicaid Services (CMS) to “engage in a nation-wide educational campaign” to communicate to Medicare Administrative Contractors, Medicare Advantage Organizations, Part A/B Qualified Independent Contractors, Part C QIC/Independent Review Entities, Quality Improvement Organizations, Recovery Audit Contractors, Administrative Law Judges, Medicare Appeals Council, Medicare providers and suppliers, subscribers to CMS listserves, and relevant 1-800 MEDICARE customer service scripts the maintenance coverage standards. Also, CMS was required to host National Calls for providers, suppliers, contractors, and adjudicators. Finally, CMS agreed to post Program Transmittals and MLN (Medicare Legal Network) Matters articles on the CMS website regarding the manual revisions.

On March 1, 2016, the Plaintiffs filed a Motion to Enforce the Settlement Agreement, arguing that the Secretary of HHS “did not adequately disavow the Improvement Standard or disseminate the Maintenance Coverage Standard,” and that
the Education Campaign “was so confusing and inadequate that little had changed as a result of [the] settlement.”23 Also, the Plaintiffs asked the Court to order the Secretary of HHS to “carry out additional education activities to address the inaccuracies and inadequacies of the original [Educational] Campaign.”24 The Court held that

the Secretary failed to fulfill the letter and spirit of the Settlement Agreement with respect to at least one essential component of the Educational Campaign. Plaintiffs have provided persuasive evidence that at least some of the information provided by the Secretary in the Educational Campaign was inaccurate, nonresponsive, and failed to reflect the maintenance coverage standard.25

After each side submitted a proposed Corrective Action Plan, the Court adopted the following Corrective Action Plan proposed by the Secretary of HHS to be completed by September 4, 2017:

1. CMS will disavow the application of the so-called "Improvement Standard" as improper under Medicare policy for the SNF, HH, and OPT benefits, while making clear that CMS has consistently denied the existence of such an "Improvement Standard." This disavowal would appear on the forthcoming Jimmo webpage and in the transmittal message notifying stakeholders of the webpage.

2. CMS is willing, through counsel, to notify Plaintiffs and the [c]ourt once the Technical Direction Letter and Health Plan Management System memorandum have been issued to, respectively, Medicare Administrative Contractors (MACs) and Medicare Advantage Organizations (MAOs).

3. CMS will publish on its website cms.gov a new webpage dedicated to the Jimmo settlement. The Jimmo webpage will, in one location, provide access to public documents related to the settlement that have been previously posted on the cms.gov website. In addition, the Jimmo webpage will direct providers and suppliers with questions regarding individual claims to the appropriate MAC. CMS will include at the top of the new Jimmo webpage a message about the settlement. This message will summarize the clarifications to Medicare policy that CMS has issued as part of the settlement. Once the Jimmo webpage is published, CMS will notify stakeholders of the webpage through existing communication channels and advise stakeholders seeking information about the settlement to visit the webpage. Before the new Jimmo webpage message is finalized, CMS will provide Plaintiffs' Counsel with a two-week period in which to provide
comments on an advance version of the message. CMS will consider any comments received from Plaintiffs' Counsel.

4. CMS will post on the forthcoming Jimmo webpage one set of Frequently Asked Questions (FAQs). This document would be developed by CMS and would include multiple questions and answers regarding the policy clarification resulting from the Jimmo settlement. CMS will provide Plaintiffs' Counsel with an opportunity to suggest potential questions for inclusion in the FAQ posting, which CMS will consider but would not be bound to accept.

5. CMS will include a message regarding the Jimmo settlement when it announces the publication of the Jimmo webpage to providers, adjudicators, contractors, and other stakeholders.

6. CMS will clarify the responses in the document entitled "Summary of the questions posed and answers provided during the December 16, 2013 Jimmo vs. Sebelius National Call for contractors and adjudicators" to address the concerns identified by the court in its August 17, 2016 Opinion and Order. CMS will disseminate the Clarified Summary to contractors and adjudicators using the same communication channels as were used for the original Summary. CMS will make clear to contractors and adjudicators that the information contained in the Clarified Summary supersedes the information contained in the original Summary. Before the Clarified Summary is finalized, CMS will provide Plaintiffs' Counsel with a two-week period in which to provide comments on an advance version of the Clarified Summary. CMS will consider any comments received from Plaintiffs' Counsel but would not be bound to accept them.

7. CMS will issue a Technical Direction Letter to MACs directing them to conduct, within a specified timeframe, additional training on the Jimmo manual clarifications. CMS would provide the MACs with materials for use in conducting this training.

8. CMS will issue a Health Plan Management System memorandum to MAOs requesting that they conduct, within a specified timeframe, additional training on the Jimmo manual clarifications. CMS would provide the MACs with materials for use in conducting this training.

9. CMS will disavow the application of the so-called "Improvement Standard" as improper under Medicare policy for the SNF, HH, and OPT benefits, while making clear that CMS has consistently denied the existence of such an "Improvement Standard." This disavowal would appear on the
forthcoming Jimmo webpage and in the transmittal message notifying stakeholders of the webpage.

10. CMS is willing, through counsel, to notify Plaintiffs and the [c]ourt once the Technical Direction Letter and Health Plan Management System memorandum have been issued to, respectively, Medicare Administrative Contractors (MACs) and Medicare Advantage Organizations (MAOs). 26

The Court also added two more requirements for the Secretary of HHS to follow. Because the Plaintiffs showed that there is still confusion over the Improvement Standard, the Court adopted Plaintiff’s proposed statement and ordered it to be included in CMS’ website regarding the Jimmo case, in the FAQs, and written materials and oral statements that the Secretary has agreed to disseminate.27 The proposed statement, also called the Corrective Statement, reads as follows:

The Centers for Medicare & Medicaid Services reminds the Medicare community of the Jimmo Settlement Agreement (January 2014), which clarified that the Medicare program will pay for skilled nursing care and skilled rehabilitation services when a beneficiary needs skilled care in order to maintain function or to prevent or slow decline or deterioration (provided all other coverage criteria are met). Specifically, the Jimmo Settlement adopted a "maintenance coverage standard" for both skilled nursing and therapy services:

Skilled nursing services would be covered where such skilled nursing services are necessary to maintain the patient's current condition or prevent or slow further deterioration so long as the beneficiary requires skilled care for the services to be safely and effectively provided.

Skilled therapy services are covered when an individualized assessment of the patient's clinical condition demonstrates that the specialized judgment, knowledge, and skills of a qualified therapist ("skilled care") are necessary for the performance of a safe and effective maintenance program. Such a maintenance program to maintain the patient's current condition or to prevent or slow further deterioration is covered so long as the beneficiary requires skilled care for the safe and effective performance of the program.

The Jimmo Settlement may reflect a change in practice for many providers, adjudicators, and contractors, who may have erroneously believed that the Medicare program pays for nursing and rehabilitation only when a beneficiary is expected to improve. The Settlement correctly implements the Medicare program's regulations governing maintenance nursing and rehabilitation in skilled nursing facilities, home health services, and
outpatient therapy (physical, occupational, and speech) and maintenance nursing and rehabilitation in inpatient rehabilitation hospitals for beneficiaries who need the level of care that such hospitals provide. These regulations are set forth in the [MBPM].

The second additional requirement is that the errors in the Summary of the Questions Posed and Answers Provided During the December 16, 2013 Jimmo v. Sebelius National Call for Contractors and Adjudicators must be corrected by holding another National Call in which the “Corrective Statement is orally disseminated.” Similarly, the Notice for the National Call must state: “This call will include corrective action mandated by the court overseeing the Jimmo settlement, clarifying the rejection of an improvement standard and explaining the maintenance coverage standard now included in the Medicare Beneficiary Policy Manual.”

According to the CMS website, there is a webpage regarding the Jimmo Settlement. The Corrective Statement is featured prominently on this webpage. This webpage includes a link to FAQs. The webpage also includes a link to the MBPM, as well as links to the Settlement Agreement, the Program Manual Clarifications Fact Sheet, the Medicare Learning Network (MLN) Matters Article on Manual Updates to Clarify SNH, HH, and OPT Coverage, the CR 8458 Manual Updated, the CR 8644 Manual Updates, and the MLN Connects Call materials. According to the Center for Medicare Advocacy, the installation of the webpage on the Jimmo Settlement is the “final step in a court-ordered Corrective Action Plan.” Perhaps now CMS and Medicare providers will stop terminating, denying, or reducing services to beneficiaries who are not improving but rather need the services in order to maintain their condition and to prevent it from worsening.

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2 Jimmo, (settlement agreement) at http://www.medicareadvocacy.org/medicare-info/improvement-standard/.
5 Id. at 5-6.
6 Id.
7 Id. at 1, para. 1.
8 Id. at 2, para. 2.
9 Id.
10 Id. at 1, para 1.
Jimmo, (settlement agreement at 8, para.1). “Such a maintenance program to maintain the patient’s current condition or to prevent or slow further deterioration is covered so long as the beneficiary requires skilled care for the safe and effective performance of the program.” Id. at page 11.


Section 1202: A Big Deal for Small Business

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Section 1202 was enacted in 1993 as an incentive for taxpayers to start and invest in certain small businesses. Currently, the statute provides an exclusion from income for any gain from the sale or exchange of “qualified small business stock” (QSBS) acquired after the effective date of the statute and held for more than five years. However, the amount of gain that is excludible from income depends on when the QSBS was originally issued. The gain exclusion is 50% for QSBS issued before February 18, 2009 and 75% for QSBS issued between February 18, 2009 and September 27, 2010. The Creating Small Business Jobs Act of 2010 (CSBJA) increased the exclusion to 100% of the total gain for all QSBS issued after September 27, 2010.

Despite this additional incentive, many businesses shied away from planning for QSBS because only the stock of C corporations qualified. Unless business founders had planned from inception to use the sale of stock as an exit strategy, founders were reluctant to voluntarily impose “double taxation” (i.e., income taxes at both the corporate level and the shareholder level) on the corporation’s taxable income.

Planning for QSBS became important for many more enterprise founders due to the reduction of the corporate rate to 21% under the 2017 tax legislation. Now is the ideal time to review the fundamentals of QSBS treatment and the particulars of section 1202.

I. Overview of Section 1202

A. Basic Mechanics

Section 1202 allows a taxpayer to exclude 100% of the eligible gain realized from the sale or exchange of QSBS issued after September 27, 2010 and held for more than five years. QSBS must be issued by a “qualified small business” and generally be acquired by the taxpayer at original issuance, either in exchange for cash or other property (not including stock) or as compensation for services rendered to the corporation (other than services an underwriter of the stock).

B. Limitations on Gain Exclusion

The statute limits the per-issuer amount that can be excluded to “eligible gain,” which is the greater of:
1) $10 million reduced by any amount the taxpayer excluded from sales or exchanges of QSBS from the same issuer in prior years, or

2) 10 times the aggregate adjusted basis of the QSBS issued by the corporation disposed of by the taxpayer during the taxable year, as measured on the original issue date.\textsuperscript{11}

Because the limitation references the higher amount of the two measurements, the potential total gain excluded from gross income may exceed $10 million. Because a corporation qualifying for the provision could have up to $50 million in assets upon inception,\textsuperscript{12} the maximum amount of gain eligible for exclusion could reach $500 million under the ten-times-basis limitation.

C. The “Qualified Small Business”

A “qualified small business” is a domestic C corporation (C-Corp) that meets three threshold requirements:\textsuperscript{13}

1) The aggregate gross assets of the corporation, including any predecessor corporation, did not exceed $50 million at all times on or after August 10, 1993, and prior to issuance.

2) The aggregate gross assets of the corporation immediately after issuance (including amounts received upon issuance) did not exceed $50 million.

3) The corporation agrees to submit reports to the Secretary and its shareholders as the Secretary may require.

Upon satisfying these requirements, the corporation must also satisfy the “active business” test to be eligible for QSBS treatment. The active business test provides:\textsuperscript{14}

1) The corporation uses at least 80% of its assets (as measured by fair market value) in the active conduct of a “qualified trade or business” (the “80% test”); and

2) The corporation is a C-Corp that is not a domestic international sales corporation (DISC) or former DISC, regulated investment company (RIC), real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), or cooperative.

For purposes of the 80% test, assets used in the active conduct of a qualified trade or business include (1) assets used in startup activities, research and development, and in-house research;\textsuperscript{15} (2) assets held for reasonably required working
capital needs;\textsuperscript{16} (3) assets held for investment that are reasonably expected to be used within two years to finance research and development or increases in the working capital needs of the business, limited to 50% of the corporation's total assets after the corporation has existed for two years;\textsuperscript{17} and (3) computer software rights leading to the production of section 543(d)(1) royalties.\textsuperscript{18}

D. Defining a "Qualified Trade or Business"

A "qualified trade or business" (QTB) is defined in section 1202(e)(3). This definition gained significant attention when the 2017 tax legislation "borrowed" and modified part of it to define and limit businesses eligible to take the deduction for qualified business income (QBI) under the new section 199A.\textsuperscript{19} Rather than identifying what a QTB is, section 1202(e)(3) sets forth what a QTB is not, namely:

1) Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business in which the principal asset of such trade or business is the reputation or skill of one or more of its employees;

2) Any banking, insurance, financing, leasing, investing, or similar business;

3) Any farming business (including the business of raising or harvesting trees);

4) Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or section 613A (i.e., oil or gas properties subject to depletion); and

5) Any business of operating a hotel, motel, restaurant, or similar business.

Beyond this statutory description, scant guidance exists – perhaps because of the relative obscurity of the QSBS statute – to help taxpayers determine whether an activity is a QTB. Two private letter rulings and one tax court case comment on the subject. In PLR 201436001, a pharmaceutical research and clinical testing company was a QTB because it did not "offer value to customers primarily in the form of services … [or] individual expertise." Likewise, in PLR 201717010, a health care technology company providing laboratory reports was a QTB because the company never offered a patient a "diagnosis or treatment recommendation," but rather only issued the reports. In Owen v. Commissioner, the Tax Court concluded that a corporation's principal asset did not include the reputation or skill of one or more employees even though the court acknowledged that the success of the corporation was attributable to its owners.\textsuperscript{20} Otherwise, practitioners may need to look to other guidance defining these terms, such as section 448 and the regulations thereunder.
E. Holding QSBS in a Pass-Thru Entity

Section 1202(g) permits taxpayers to hold QSBS through any partnership, subchapter S corporation, RIC, or common trust fund. Generally, however, a transfer of originally issued QSBS to a pass-thru entity will cause the QSBS to cease to be treated as QSBS. For example, if QSBS is transferred to a partnership in exchange for a partnership interest, gain realized on the disposition of the stock by the partnership would not be eligible for exclusion under section 1202(a).

Any QSBS held via pass-thru entity will enjoy the same treatment as QSBS held directly to the extent the pass-thru entity meets all requirements otherwise applicable to an individual holder of QSBS. Taxpayers must hold the interest in the pass-thru entity for at least five years, as well; for instance, a taxpayer may not acquire an interest in a partnership that has held QSBS for ten years, then sell the interest two days later and receive QSBS treatment. Disallowance of QSBS treatment would likewise apply if the aforementioned hypothetical taxpayer received a distributive share of partnership income attributable to the sale of QSBS shortly after acquisition of a partnership interest.

F. Allowable Transfers and Entity Conversions

Section 1202(h) allows for transferees to receive QSBS that retains its character as QSBS in certain permitted transfers. The list of permitted transfers generally reflects a policy of blessing certain QSBS dispositions that provide for carry-over basis treatment. For instance, if a taxpayer holds QSBS through a tax partnership from first issuance, distribution of the QSBS from the partnership to the taxpayer in a non-recognition transaction will allow the taxpayer to tack the partnership’s QSBS eligibility and holding period to her own. If a taxpayer gifts or bequeaths QSBS, the recipient of the QSBS will also be allowed to tack QSBS eligibility and holding period.

Tax-deferred incorporations and reorganizations enjoy similar treatment: any successor stock received in exchange for QSBS will also retain its character and holding period. If a taxpayer holds QSBS and exchanges it for non-QSBS in a section 351 or section 368 transaction, the non-QSBS received will be treated as QSBS to the extent of the built-in gain on the date of the reorganization.

For example, assume Acme Corp. issues QSBS to Tom Taxpayer in 2012, and Tom Taxpayer has a basis of $1 per share. In 2018, after meeting all applicable requirements imposed by section 1202 for the entirety of Tom Taxpayer’s holding period, Acme Corp. merges with Widget Corp. Assume that the adjusted basis of Acme Corp. stock in the hands of Tom Taxpayer remains $1, but Widget Corp. values Acme Corp.’s shares at $11 per share. Unlike Acme Corp., the stock of Widget Corp. is non-
QSBS. Under section 1202(h)(4)(B), the Widget Corp. stock that Tom Taxpayer received in exchange for his Acme Corp. stock is treated as QSBS to the extent of the $10-per-share built-in gain at the time of the merger. If Tom Taxpayer sells his Widget Corp. stock when it appreciates to $26 per share, he will enjoy a section 1202(a) exclusion for $10 per share of his gain but will not be able to apply section 1202(a) to the remaining $15 per share of his gain.

G. Section 1045: QSBS Rollovers

Section 1045 allows a taxpayer to “roll over” gain on the disposition of QSBS into QSBS of a different issuer, provided the QSBS is held for more than six months prior to disposition and the rollover occurs within 60 days. If the taxpayer does not purchase “replacement” QSBS with a fair market value equal to or greater than the “relinquished” QSBS, the taxpayer will recognize “boot” in the form of capital gain, similar to the treatment of a section 1031 exchange. For purposes of determining the five-year QSBS holding period, the taxpayer’s holding period in the “relinquished” QSBS will count toward the holding period of the “replacement” QSBS.

For example, assume Tina Taxpayer has a $100,000 adjusted basis and a three-year holding period in her Acme Corp. QSBS. Tina then sells her Acme Corp. QSBS for $1 million. Within 60 days of her original sale, Tina purchases Widget Corp. QSBS for $850,000. Tina takes a $100,000 carry-over basis in her Widget Corp. QSBS and recognizes $150,000 of capital gain. To avoid recognition of capital gain entirely, Tina could have reinvested the remaining $150,000 into Widget Corp. QSBS or the QSBS of a different issuer. Tina’s three-year holding period in the Acme Corp. QSBS carries over to her new Widget Corp. QSBS. Thus, Tina would only need to hold her Widget Corp. QSBS for two additional years to qualify for gain exclusion from the sale or exchange of the Widget Corp. QSBS.

II. Traps for the Unwary

A. Put Options as Dispute Resolution

Section 1202(j) prohibits the application of Section 1202(a) to exclude gain from the sale of QSBS from a taxpayer’s gross income if the taxpayer holds an “offsetting short position” with respect to the QSBS. Although the statute was clearly designed for taxpayers who actively seek out strategies to mitigate their economic risk of loss for QSBS holdings, no statutory or regulatory exception exists for the common dispute resolution strategy of allowing shareholders to possess a put option for their stock that would allow the shareholder to exit by compelling a sale to either another shareholder or the corporation itself. Practitioners who are not mindful of section 1202(j) could inadvertently trigger its application by attempting in good faith to set up a method for the corporation to avoid a crippling impasse between its principals.
B. Failure to Monitor Assets or Spend Working Capital

As described above, section 1202(e) measures the “active business requirement” by examining how the corporation uses its assets. Section 1202(e)(1)(A) requires the corporation to use 80% of its assets in the active conduct of a qualified trade or business. While section 1202(e) provides a list of exceptions, failure to meet the requirements of section 1202(e) could result in a tax disaster. Corrective action may cure such a failure, but any rescue attempt must be completed quickly to allow the taxpayer to meet the “substantially all” requirement in section 1202(c)(2)(A). Because no bright-line standard exists for measuring “substantially all of the taxpayer’s holding period” for QSBS, time is of the essence for taxpayers and their advisors to discover and remedy any facts or circumstances causing less than 80% of assets to be used in a qualified trade or business.

III. Interplay with the 2017 Tax Legislation

The 2017 tax legislation cut the statutory income tax rate on C-Corps from 35% (the maximum rate in a graduated rate provision) to a 21% flat rate, making the C-Corp a significantly more attractive choice of entity. Other changes in the tax act also favored C-Corps, such as the limitation on a non-corporate taxpayer’s deduction for state and local income, property, and sales/use taxes, which is not applicable to C-Corps. The introduction of tax incentives for investment in qualified opportunity zones (QOZs) might be the second most important aspect of the 2017 tax legislation to favor planning for QSBS treatment. In brief, Congress provided for the deferral and partial forgiveness of capital gain that is reinvested into a QOZ and the exclusion from gross income of all subsequent appreciation, provided certain conditions have been met. Depending on Treasury’s reconciliation of the incentives in section 1202 with the incentives in section 1400Z-2, seizing the tax advantages of QSBS could become even more compelling if the QSBS also satisfies the requirements to be treated as QOZ stock. In that case, adroit tax planning could result in the permanent exclusion from taxation of gain on the sale of the QSBS, provided forthcoming regulations do not prohibit the technique. The overlap of the QSBS and QOZ systems will require detailed rules, which are unlikely to be a part of the initial wave of QOZ guidance expected in the coming months.

IV. Conclusion

Section 1202 did not receive much attention from the tax community at large because of the relative unattractiveness of C-Corps, but with the passage of the 2017 tax legislation, now is the ideal time for practitioners to review the inner workings of the statute. Despite existing statutory and administrative ambiguity, taxpayers can obtain significant benefits from issuing QSBS, especially if they work closely with their tax
advisors to avoid traps for the unwary. In the current environment, the cost-benefit analysis in the choice of entity decision will favor C-Corps more frequently when QSBS treatment applies. Although shareholders, accountants, and lawyers will need to jointly navigate the setup and operation of a corporation issuing QSBS, the reward at the end of the journey is well worth the complexity, and the tax advantages may become even more enticing if Treasury promulgates taxpayer-favorable regulations under section 1400Z-2.

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The views expressed are those of the author and do not necessarily reflect the views of Ernst & Young LLP or any other member firm of the global Ernst & Young organization.

4 § 1202(a)(1). This assumes the taxpayer holds no offsetting position, such as a short sale, put option, hedge, or the like. See § 1202(j).
5 See P.L. 103-66, § 13113(a); P.L. 111-5, § 1241(b).
6 § 1202(a)(4).
7 § 1202(c)(1).
9 § 1202(a)(1), as modified by § 1202(a)(4).
10 § 1202(c)(1). An exception described further herein exists for certain conversions and non-recognition transactions.
11 § 1202(b)(1). For taxpayers filing separately, the limitation in (1) is $5 million instead of $10 million.
12 § 1202(d)(1)(A).
13 § 1202(d)(1).
14 § 1202(e)(1); § 1202(e)(4).
15 § 1202(e)(2).
16 § 1202(e)(6)(A).
17 § 1202(e)(6)(B).
18 § 1202(e)(8).
19 P.L. 115-97, § 11011(a). In Proposed Regulation 107892-18, the Treasury Department and IRS defined many of the terms listed above. However, they indicated that such guidance “applies only to section 199A, not sections 1202 and 448.”
20 T.C. Memo 2012-21.
21 § 1202(g)(4).
22 § 1202(h).
23 § 1202(g)(2).
24 § 1202(g)(3).
25 § 1202(h)(2)(C).
26 § 1202(h)(2)(A), (B).
27 § 1202(h)(4).
28 Note this applies to section 351 transactions only to the extent the corporation issuing the non-QSBS has section 368(c) control of the corporation originally issuing the QSBS. § 1202(h)(4)(D).
29 § 1045(a)(1).
30 § 1045(b)(5); see § 1202(f)(2).
31 P.L. 115-97, § 13001(a).
While a complete discussion of qualified opportunity zones is beyond the scope of this article, we beseech readers to familiarize themselves with the concept because of its seismic effect on a wide variety of taxpayers. See generally §§ 1400Z-1, 1400Z-2.

A QOZ is a population census tract located in a low-income community that is designated as a qualified opportunity zone. Section 1400Z-1(a).

At first blush, § 1202 does not appear to conflict with the congressional intent of §§ 1400Z-1 and 1400Z-2. If this hypothesis proves correct, Treasury could actually adopt the opposite approach and bless the complete exclusion of the deferred capital gain from income and the complete exclusion of any subsequent appreciation from gross income if the QOZ investment is in the form of QSBS, despite the mandate of § 1400Z-2(b)(1)(B) that any deferred capital gain be recognized by December 31, 2026, regardless of whether a realization or recognition event has occurred.
In the Matter of the Estate of Violet Nelson, Deceased

By Steven K. Mignogna and Melissa O. Dibble

In this decision, the court looked beyond the plain language of a trust to the settlor's probable intent to find that the settlor intended to disinherit certain of her grandchildren.

Violet Nelson left trust property to her “grandchildren.” On its face, therefore, the trust apparently benefited all six children of Violet’s three children – sons Jacob (known as “Jack”) and Robert, and daughter Jacoba.

Jack was the trustee. He sought a declaratory judgment that Jacoba’s two sons were not included among Violet’s “grandchildren”; he argued that Violet did not consider Jacoba’s sons to be her “grandchildren” because Jacoba married outside their Orthodox Jewish faith. Jack contended that, after Jacoba’s marriage in 1970, Violet mourned Jacoba as if she were dead and cut off contact with her.

Indeed, the attorney who drafted the trust understood that Violet did not count Jacoba’s children among her grandchildren, nor even acknowledge their existence. The drafting attorney used the word “grandchildren” to include only Jack’s and Robert’s children. The attorney advised that he reviewed the trust with Violet, explained that only Jack’s and Robert’s children would benefit. He further stated that Violet understood.

Jack acknowledges that after years of silence between Violet and Jacoba, the two attempted reconciliation in 1986. But he contends relations were cut off again after Violet learned that Jacoba’s children had been baptized. Jack points to an unprobated will Violet signed in 1988. It identified Jacoba as her daughter, but omitted Jacoba’s sons among the listed grandchildren, and expressly left nothing to Jacoba or her “surviving issue.” A 2001 codicil also referred only to her “four grandchildren.”

One of Jacoba’s sons, Jared Lina, opposed Jack’s declaratory judgment action. He contended the trust was clear on its face. He also presented extrinsic evidence to show that Violet intended to include all of her grandchildren in the trust, without exception.

After discovery, Jared and Jack filed cross-motions for summary judgment. The trial judge determined that Jared and his brother were trust beneficiaries, in reliance mainly on the plain meaning of “grandchildren.” The judge concluded that In re Estate of Gabrellian, barred the court from considering extrinsic evidence.

The Appellate Division explained at the outset that a court’s primary goal in interpreting a trust agreement is to fulfill the settlor’s intent. “The court may even read a trust or will ‘contrary to its primary signification’ if necessary ‘to prevent the intention of the testator from being defeated by a mistaken use of language.’”

The Appellate Division clarified that the focus is on probable intent, as codified at N.J.S.A. 3B:3-33.1:
The Court “continue[s] to adhere to the view of the doctrine of probable intent expressed in Fidelity Union.” Payne, 186 N.J. at 335. The doctrine does not permit a court to “conjure up an interpretation or derive a missing testamentary provision out of whole cloth.” Engle v. Siegel, 74 N.J. 287, 291 (1977) (quoting In re Estate of Burke, 48 N.J. 50, 64 (1966)). However, a court “may, on the basis of the entire will, competent extrinsic evidence and common human impulses strive reasonably to ascertain and carry out what the testator probably intended . . . .” Ibid. (quoting Burke, 48 N.J. at 64).5

The court further explained that fulfilling a settlor’s or testator’s probable intent takes two forms: interpretation; and reformation. The former entails discerning the meaning of language already in the instrument. Reformation “involves remaking or modifying an instrument, to correct mistakes, to fulfill an unexpressed intention, or to address circumstances that were unforeseen.”6

The appeals court further explained the distinction in the burdens of proof: “The preponderance-of-the-evidence standard of proof applies to interpretation; however, the more rigorous clear-and-convincing standard of proof applies to reformation.”7 “The higher standard of proof for reformation is warranted to prevent reliance on ‘contrived evidence.’”8

The Appellate Division explained that, as to interpretation, “our courts have long disapproved the so-called ‘plain meaning rule,’ which bars a court from looking beyond the face of a writing to consider extrinsic evidence in ascertaining intent.” Indeed, “these principles of interpretation apply with greater force in interpreting trusts and wills.”9

The appeals court continued:

Against the backdrop of this substantial authority, we cannot endorse the general statement in Gabrellian, 372 N.J. Super. at 443, upon which the trial court relied (and for which we intend no criticism), that “[t]he doctrine of probable intent is not applicable where the documents are clear on their face and there is no failure of any bequest or provision.” As noted, a court may resort to extrinsic evidence to unveil ambiguity that does not appear on the document’s face.

Nor is our Court’s long-held resistance to the “plain meaning rule” limited to cases where there is a failure of a bequest . . . .

We should not tolerate interpreting a trust to provide benefits the settlor did not intend.10

The Appellate Division thus reversed the grant of summary judgment against Jack and remanded the matter:
We are satisfied that, extending to Jack all favorable inferences, extrinsic evidence demonstrated that “grandchildren,” as the term was used in this trust, was ambiguous. While “grandchildren” generally means “the children of children,” Jack presented evidence that Violet used the term in a different sense, personal to her ….

Jack has presented sufficient extrinsic evidence to support a conclusion that “grandchildren” meant not all children of Violet’s children, but the children of her sons, who continued to practice her religion, and not the sons of her daughter who inter-married. Having established ambiguity, Jack is obliged to demonstrate by a preponderance of the evidence that his proposed meaning is the one that fulfils Violet’s intent. He may do so by marshaling extrinsic evidence. Of course, Jared may counter that with evidence of his own.

Even if the court as fact-finder is not persuaded that “grandchildren” excluded Jacoba’s children, Jack should be allowed to establish that the scrivener made a mistake in using the word, and in drafting the trust without identifying the four grandchildren Violet intended to benefit. That would require reformation of the trust. Jack would bear the burden of demonstrating that general intent by clear and convincing evidence.11

The import of the Nelson decision, is that courts may look beyond the plain language of the trust agreement or will when discerning the settlor’s or testator’s probable intent. The case also highlights the important distinction between the standard of proof for an interpretation issue (such as in this case) -- which is a preponderance-of-the-evidence standard -- and a reformation issue -- which is a clear-and-convincing evidence standard. Seeking reformation of a testamentary instrument requires a higher burden of proof than seeking interpretation of that instrument.


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4 Id. at 158 (citations omitted).

5 Id. at 158-59.

6 Id. at 160.

7 Id.

8 Id. at 161 (citations omitted).

9 Id. at 162.

10 Id. at 163 (citations omitted).

11 Id. at 166.
Make Life Better: Leveraging Tech

Practical Tips on Using Technology to Improve Your Practice and Your Day

Keith H. Mullen

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214.780.1333
Make Life Better: Leveraging Technology

Is this you? Technology has NOT improved my work day.
I'm just trying to do more work . . .
at a faster pace . . .
and with little or no help on "how" to use it

Problem: I need a few PRACTICAL tips . . . before I . . .

PRACTICAL TIPS

On Your Desktop
- Outlook Mail
- Keyboard (Outlook; Word; Windows)
- Adobe Pro
- On-line Resources
- Other Favorites

Page(s)
1 - 6
7 - 9
10 & 11
12
13

Managing Workflow
14 & 15

Document Preparation
16

Metadata
17 & 18

Advanced Tips
19
**Desktop Overview: Mail**

**Is this you?**  I use my email Mailbox as "digital" file cabinets and folders.

**Problem:**  Email is KILLING me. A large portion of my day is WASTED by clicking, dragging and searching emails.

**TIPS: Solutions in MAIL settings for . . .**

1. Collecting your emails in each deal folder
2. Spell-check does NOT include words in ALL CAP WORDS
3. Setting up notifications of new email arrival
4. Setting up your signature AND notice of NO intent of an electronic agreement
5. What happens (to an email) after you reply to or forward the email
6. No more prompts for a Read Receipt

---

**Step 1**  In Outlook, CLICK > File

**Step 2**  CLICK > Options
**Problem:** I waste time by "dragging" e-mails from the "sent" folder, or from the "inbox" folder to another folder (as we "bcc" ourselves in every e-mail). I want to stop this madness.

**TIP:** SET UP MAIL TO AUTOMATICALLY "SAVE" A COPY OF EACH E-MAIL TO THE FOLDER FROM WHICH THE EMAIL IS GENERATED (OR SENT)
- move new email to the "deal" email folder
- then read and respond/reply ("from" the email in the deal folder)

---

**Step 1** Create "deal" folder in Outlook Mail (In the left pane of Mail, right-click where you want to add the folder, and then click New Folder)

**Step 2**
- Click: File > Options > Mail
- Under "Save messages" -
  - Select-check the box labeled "When replying to a message that is not in the Inbox, save the reply in the same folder"

**Step 3**
- Under "Save messages" -
  - Select-check the box labeled "Save copies of messages in the Sent Items folder"
TIP(S)# - 2 & 3 - SPELL CHECK and NOTIFICATIONS

Problem: Spell check (of an email) IGNORES words in ALL CAPS. AND, I waste time slogging through my cluttered screen as I look for my email inbox (in order to check on new email).

TIP: Turn off the "Ignore Words in All Caps" setting in spell check; AND Turn on taskbar and/or desktop alerts for arrival notifications of new emails

Step 1 In the "ABC" panel, CLICK/CHECK box for "Always check spelling before sending"

Step 2 In the "ABC" panel, CLICK box labeled "Spelling and Autocorrect"
- CLICK the "Proofing" tab
- Do NOT check the box labeled "Ignore words in UPPERCASE"
Problem: Constantly adding your contact information to each email; AND, concerned that an email will create a binding agreement

TIP: Set up your email signature(s) and contact information; and add language expressly disclaiming your intent to enter into an agreement via email

Step 1 In the "Create or modify signatures for messages" panel, CLICK the box labeled "Signatures"

Step 2
a. CLICK the "E-mail Signature" tab, for CLICK the "New" box
b. In the "E-mail account" box: select the correct email account
c. In the "New messages" and the "Replies/forwards" box: select the correct signature
d. In the "Edit signature" box: select the style, and if you want to attach your Business Card; then type your contact information
e. Consider adding a disclaimer of creating an agreement by electronic means

Sample disclaimer of creating an electronic agreement

Unless it specifically so states, this communication does not reflect an intention by the sender or the sender’s client or principal to conduct a transaction or make any agreement by electronic means. Unless it specifically so states, anything contained in this message or in any attachment shall satisfy the requirements for a writing, and anything contained herein shall constitute a contract or electronic signature under the Uniform Electronic Transactions Act or any other statute governing electronic transactions.
**Problem:** Avoid clicking to close the original email after you reply or forward an email

**TIP:** Automatically close the original message

---

**Step 1** Scroll to the "Replies and forwards" panel

**Step 2** CLICK the box labeled "Close original message window when replying or forwarding"
**Problem:** Avoid clicking to respond to read receipts

**TIP:** Automatically avoid the decision (and "clicking") of NOT sending a read receipt

**Step 1** Scroll down to the "Tracking" panel

**Step 2** CLICK the button labeled "Never sent a read receipt"
**Outlook Keyboard Shortcuts**


<table>
<thead>
<tr>
<th>To do this</th>
<th>Press</th>
</tr>
</thead>
<tbody>
<tr>
<td>Close</td>
<td>Escape or Enter</td>
</tr>
<tr>
<td>Go to <strong>Home</strong> tab</td>
<td>Alt+H</td>
</tr>
<tr>
<td>New message</td>
<td>Ctrl+Shift+M</td>
</tr>
<tr>
<td>Send</td>
<td>Alt+S</td>
</tr>
<tr>
<td>Insert file</td>
<td>Alt+N, A, F</td>
</tr>
<tr>
<td>New task</td>
<td>Ctrl+Shift+K</td>
</tr>
<tr>
<td>Delete</td>
<td>Delete (when a message, task, or meeting is selected)</td>
</tr>
<tr>
<td>Search</td>
<td>Ctrl+G, Alt+H, R, P</td>
</tr>
<tr>
<td>Reply</td>
<td>Alt+H, R, P</td>
</tr>
<tr>
<td>Forward</td>
<td>Alt+H, F, W</td>
</tr>
<tr>
<td>Reply All</td>
<td>Alt+H, R, A</td>
</tr>
<tr>
<td>Copy</td>
<td>Ctrl+C or Ctrl+Insert</td>
</tr>
<tr>
<td>NOTE: Ctrl+Insert is not available in the <strong>Reading</strong> pane.</td>
<td></td>
</tr>
<tr>
<td>Send/Receive</td>
<td>Alt+S, S</td>
</tr>
<tr>
<td>Go to calendar</td>
<td>Ctrl+2</td>
</tr>
<tr>
<td>Create appointment</td>
<td>Ctrl+Shift+A</td>
</tr>
<tr>
<td>Move to folder</td>
<td>Alt+H, M, V, select folder from list</td>
</tr>
</tbody>
</table>

**Search**

<table>
<thead>
<tr>
<th>To do this</th>
<th>Press</th>
</tr>
</thead>
<tbody>
<tr>
<td>Find a message or other item</td>
<td>Ctrl+E</td>
</tr>
<tr>
<td>Clear the search results</td>
<td>Esc</td>
</tr>
<tr>
<td>Expand the search to include <strong>All Mail Items</strong>, <strong>All Calendar Items</strong>, or <strong>All Contact items</strong>, depending on the module you are in</td>
<td>Ctrl+Alt+A</td>
</tr>
<tr>
<td>Use Advanced Find</td>
<td>Ctrl+Shift+F</td>
</tr>
<tr>
<td>Create a Search folder</td>
<td>Ctrl+Shift+F</td>
</tr>
<tr>
<td>Search for text within an open item</td>
<td>F4</td>
</tr>
<tr>
<td>Find and replace text, symbols, or some formatting commands when in the <strong>Reading</strong> pane or in an open item</td>
<td>Ctrl+H</td>
</tr>
<tr>
<td>Expand search to include items from the current folder</td>
<td>Ctrl+Alt+K</td>
</tr>
<tr>
<td>Expand search to include subfolders Ctrl+Alt+Z Flags</td>
<td>Ctrl+Alt+Z</td>
</tr>
</tbody>
</table>
# Word Keyboard Shortcuts: CTRL + . . . .

This table shows the most frequently used shortcuts in Microsoft Word.

<table>
<thead>
<tr>
<th>To do this</th>
<th>Press</th>
</tr>
</thead>
<tbody>
<tr>
<td>Go to “Tell me what you want to do”</td>
<td>Alt+Q</td>
</tr>
<tr>
<td>Open</td>
<td>Ctrl+O</td>
</tr>
<tr>
<td>Save</td>
<td>Ctrl+S</td>
</tr>
<tr>
<td>Close</td>
<td>Ctrl+W</td>
</tr>
<tr>
<td>Cut</td>
<td>Ctrl+X</td>
</tr>
<tr>
<td>Copy</td>
<td>Ctrl+C</td>
</tr>
<tr>
<td>Paste</td>
<td>Ctrl+V</td>
</tr>
<tr>
<td>Select all</td>
<td>Ctrl+A</td>
</tr>
<tr>
<td>Bold</td>
<td>Ctrl+B</td>
</tr>
<tr>
<td>Italic</td>
<td>Ctrl+I</td>
</tr>
<tr>
<td>Underline</td>
<td>Ctrl+U</td>
</tr>
<tr>
<td>Decrease font size 1 point</td>
<td>Ctrl-[</td>
</tr>
<tr>
<td>Increase font size 1 point</td>
<td>Ctrl+]</td>
</tr>
<tr>
<td>Center text</td>
<td>Ctrl+E</td>
</tr>
<tr>
<td>Left align text</td>
<td>Ctrl+L</td>
</tr>
<tr>
<td>Right align text</td>
<td>Ctrl+R</td>
</tr>
<tr>
<td>Cancel</td>
<td>Esc</td>
</tr>
<tr>
<td>Undo</td>
<td>Ctrl+Z</td>
</tr>
<tr>
<td>Re-do</td>
<td>Ctrl+Y</td>
</tr>
<tr>
<td>Zoom</td>
<td>Alt+W, Q, then tab in Zoom dialog box to the value you want.</td>
</tr>
</tbody>
</table>

Quickly switch between Windows

Dialog box keyboard shortcuts

<table>
<thead>
<tr>
<th>Press this key</th>
<th>To do this</th>
</tr>
</thead>
<tbody>
<tr>
<td>F4</td>
<td>Display the items in the active list</td>
</tr>
<tr>
<td>Ctrl + Tab</td>
<td>Move forward through tabs</td>
</tr>
<tr>
<td>Ctrl + Shift + Tab</td>
<td>Move back through tabs</td>
</tr>
</tbody>
</table>


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The monthly subscription to Adobe Acrobat Pro DC is one of my favorite tools - to annotate documents, to convert documents into word, to create and edit PDFs, to securely sign PDFs, etc.


<table>
<thead>
<tr>
<th>Create PDFs</th>
<th>Edit PDFs</th>
<th>Sign and collect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convert documents and images to PDF files</td>
<td><strong>NEW</strong> Edit PDF text and images with full-page paragraph ruler</td>
<td><strong>NEW</strong> Fill, sign, and send forms</td>
</tr>
<tr>
<td>Create PDFs from any application that prints</td>
<td><strong>NEW</strong> Turn PDFs into editable Microsoft Word, Excel, or PowerPoint files with improved formatting accuracy</td>
<td>Measure the distance, area, and perimeter of objects in PDFs</td>
</tr>
<tr>
<td>Create, protect, and send PDFs in popular Microsoft Office apps for Windows</td>
<td>Convert PDFs to JPEGs, TIFF, or PNG image formats</td>
<td><strong>NEW</strong> Capture your signature with your mobile device to use across Adobe Document Cloud</td>
</tr>
<tr>
<td>Combine multiple documents in one PDF</td>
<td>Insert, delete, and organize pages in a PDF</td>
<td>Add comments to PDFs with a highlighter, sticky notes, and more</td>
</tr>
<tr>
<td>Convert web pages to interactive PDFs, complete with links</td>
<td>Add bookmarks, headers, numbering, and watermarks</td>
<td><strong>NEW</strong> Give and get fast, clear feedback with all-new commenting tools</td>
</tr>
<tr>
<td>Prevent others from copying or editing information in PDFs</td>
<td><strong>NEW</strong> Turn scanned paper documents into instantly editable PDFs</td>
<td>Turn paper or Word docs into fillable PDF forms</td>
</tr>
<tr>
<td>Create a password-protected PDF</td>
<td><strong>NEW</strong> Compare two versions of a PDF to review all differences</td>
<td><strong>NEW</strong> Host SharePoint-based shared reviews on Office 365 sites</td>
</tr>
<tr>
<td>Turn scanned documents into searchable PDFs with selectable text</td>
<td>Automatically optimize PDFs to reduce file size</td>
<td>Work with certificate signatures</td>
</tr>
<tr>
<td><strong>NEW</strong> Recognize text in scans, and then preview and correct suspect errors with a side-by-side view</td>
<td><strong>NEW</strong> Add audio, video, and interactive objects to PDFs</td>
<td>Collect comments from others in one PDF file</td>
</tr>
<tr>
<td><strong>NEW</strong> Automatically fix photos of documents to remove backgrounds and adjust perspective</td>
<td><strong>NEW</strong> Redact to permanently remove sensitive information in PDFs</td>
<td>Choose comments and export to Word</td>
</tr>
<tr>
<td><strong>NEW</strong> Turn Adobe Photoshop (PSD), Illustrator (AI), or InDesign (INDD) files into PDFs from your desktop or mobile device</td>
<td><strong>NEW</strong> Preflight and prepare files for high-end print production</td>
<td>Mark PDFs with stamps, such as &quot;approved&quot; or &quot;draft&quot;</td>
</tr>
<tr>
<td><strong>NEW</strong> Record, delete, or rotate PDF pages on your iOS or Android tablet</td>
<td><strong>NEW</strong> Add Bates numbering to legal documents</td>
<td><strong>NEW</strong> Collect e-signatures from others and track responses in real time</td>
</tr>
<tr>
<td></td>
<td><strong>NEW</strong> Edit text and organize pages in PDFs on your iPad</td>
<td>Compare two versions of a document to see what's changed</td>
</tr>
</tbody>
</table>
Review and Annotate a Title Commitment

First American
Commitment

EXHIBIT "A"

Legal Description to be used:
0.70 acre to be surveyed out of
ALL THAT CERTAIN TRACT OR

c. to filled-in lands, or artificial islands, or
d. to statutory water rights, including riparian rights, or
e. to the area extending from the line of mean low tide to the
   to that area or easement along and across that area.

(Applies to the Owner's Policy only.)

5. Standby fees, taxes and assessments by any taxing authority for the year 2017, and subsequent years;
and subsequent taxes and assessments by any taxing authority for prior years due to change in land

Rights of Parties in Possession. (OWNER POLICY ONLY)

a. Rights of tenants, as tenants only, under unrecorded leases or rental agreements.

b. Rights of tenants, as tenants only, under unrecorded leases or rental agreements.

c. Rights of tenants, as tenants only, under unrecorded leases or rental agreements.

d. Rights of tenants, as tenants only, under unrecorded leases or rental agreements.

e. Rights of tenants, as tenants only, under unrecorded leases or rental agreements.

f. Rights of tenants, as tenants only, under unrecorded leases or rental agreements.

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f. Rights of tenants, as tenants only, under unrecorded leases or rental agreements.
On-line Resources

These are some of my favorite, go-to, on-line resources:

- UT Law CLE, online briefcase
- State Bar CLE (small fee or free)
- State Bar: FREE access to Fastcase (state & federal cases and laws)
- State Bar: FREE access to Casemaker (state & federal cases and laws)

Free access to all State Bar of Texas CLE if a member of the Texas Bar College, or to others upon payment of annual fee.

Keith H. Mullen
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Other Favorites

These are some of my favorite tech tools:

- ScanSnap iX500
- Windows Snipping Tool
- Mac OS "snipping" tool

How to take a screenshot of a selected portion of your screen

1. Press Shift-Command-4. The pointer changes to a crosshair.
2. Move the crosshair to where you want to start the screenshot, then drag to select an area.
   While dragging, you can hold Shift, Option, or Space bar to change the way the selection moves.
3. When you’ve selected the area you want, release your mouse or trackpad button. To cancel, press the Esc (Escape) key before you release the button.
4. Find the screenshot as a png file on your desktop.

How to take a screenshot of a window

1. Press Shift-Command-4. The pointer changes to a crosshair.
2. Press the Space bar. The pointer changes to a camera.
3. Move the camera over a window to highlight it.
4. Click your mouse or trackpad. To cancel, press the Esc (Escape) key before you click.
5. Find the screenshot as a png file on your desktop.

Sometimes, the best way to communicate is to take a screenshot, and even annotate it

- Annotate the screen shot
- Share it
- Save it

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One key to managing work flow is in the use of visualization tools. I use a tool that is based upon a visual productivity system designed by Toyota for just-in-time manufacturing, called "Kanban" (which means "signboard" in Japanese).

Simply stated, each card represents a specific task (or deal) that can be accomplished and marked as completed (or closed).

The cards are organized into these categories or columns:
- Doing
- Waiting
- Delegated
- To Do
- Post Closing Tracking
- Done
- Ideas

My Favorite Work Flow Management Tool: Trello

- Kanban
- Boards: for all work, and/or specific projects
- Cards using Kanaban
- Trello [https://trello.com]

Boards are made up of lists. They can be steps in a workflow, categories, or whatever you want them to be. Make as many lists as you need on a board.

Add cards to lists to keep track of everything you need to do or remember: Content to write, bugs to fix, leads to contact, anything!

Drag cards across lists to show progress...

Click to open cards, where team members can add details like checklists, due dates, files, and comments.

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Managing Work Flow

**Trello**

- Client/Matter Detailed Description
- Templates Comments
- Checklists
- Attachments
- Due Dates

1. Checklist
2. Add Checklist
3. Add
4. Add an item...
Automating Loan Document Preparation

**Favorite Loan Document Preparation Tool**

Benefits (Problems Solved)

- Risk Reduction (Accurate Business Content)
- Enhanced Compliance (Conform to Unique Requirements)
- Operational Efficiency (66% reduction in initial draft)

1,000,000 users in 11,000 companies across 60 different countries

HotDocs Server
HotDocs Server enables web-based document automation, allowing access to HotDocs templates in any commonly available web browser.

Cloud Services
HotDocs Cloud Services enables you to have the industry’s leading, browser-based, document automation technology without the upfront cost of...

HotDocs Developer
HotDocs Developer gives you the ability to transform documents into powerful templates.

HotDocs User
HotDocs User is a desktop software program that allows you to organize, access, and run HotDocs document-automation templates.

LawBase

iManage

https://www.hotdocs.com/
**Metadata**

**What is it?**

Metadata is digital data that is not immediately visible when the document is opened by the recipient of the email, but can be read either through the use of certain commands available in word-processing software or through the use of specialized software. In this case, the metadata includes information revealing confidential information of the client of Lawyer A related to ongoing settlement negotiations. Lawyer B has no reason to believe that Lawyer A intended to include this metadata in the attachment.

**OPINION NO. 665, DECEMBER 2016**

**QUESTIONS PRESENTED**

1. *What are a Texas lawyer’s obligations under the Texas Disciplinary Rules of Professional Conduct to prevent the inadvertent transmission of metadata containing a client’s confidential information?*


   Can be taken to prevent or minimize the transmission of metadata. Lawyers therefore have a duty to take reasonable measures to avoid the transmission of confidential information embedded in electronic documents, including the employment of reasonably available technical means to remove such metadata before sending such documents to persons to whom such confidential information is not to be revealed pursuant to the provisions of Rule 1.05. Commonly employed methods for avoiding

**Why do I care?**

ABA lists other state ethics opinions: [http://bit.ly/ABAmData](http://bit.ly/ABAmData)

This must be something NEW . . . it's a 2016 ethics opinion

**NO . . . NOT UNTIL**

- p. 17 -

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Metadata: Back to the Future

NEW? The NSA reported on metadata in . . . 2005

How do I deal with it?

1. Buy a software program, or use metadata scrubber features in your document management program
2. Small Firm or Solo: tools "in" Adobe (PDF) and in Word

<table>
<thead>
<tr>
<th>Tools</th>
<th>Save Word doc to PDF, then use Adobe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Protect &amp; Standardize: Redact</td>
<td>OR remain in Word and:</td>
</tr>
<tr>
<td>Sanitize Document</td>
<td>Open Word Document &gt; File</td>
</tr>
<tr>
<td>Save new PDF document</td>
<td>Click Save As; Type new File name (to save copy as a precaution)</td>
</tr>
</tbody>
</table>

Easiest path: save
Word doc to PDF
and use PDF Pro DC tools

<table>
<thead>
<tr>
<th></th>
<th>In the new copy: Click File &gt; Info</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Click: Check for issues &gt; Inspect Document</td>
</tr>
<tr>
<td>In Document Inspector dialog box: select the check boxes to chose types of data that you want to inspect</td>
<td></td>
</tr>
<tr>
<td>Click: Inspect</td>
<td>Review the results</td>
</tr>
<tr>
<td>Click: Remove All next to the inspection results for types of hidden content that you want removed (NOTE: use of this feature will clean track-changes in the Word document)</td>
<td></td>
</tr>
</tbody>
</table>

Word Help: inspect docs for metadata:
Make Life Better: Leveraging Technology - ADVANCED TIPS

- Already mastered all of this, and wanting more?
  Consider expanding your communication skills to include these tips

---

Easily share website links using Bitly

Why?
- Shorter URL
- URL make sense

[Link to Bitly]
http://www.abrahamlincolnonline.org/lincoln/speeches/gettysburg.htm

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Communicate with words AND GRAPHICS

Graphic design is art with a purpose. It involves a creative and systematic plan to solve a problem or achieve certain objectives, with the use of images, symbols or even words. It is visual communication and the aesthetic expression of concepts and ideas using various graphic elements and tools.

Make Life Better: Leveraging Tech
Practical Tips on Using Technology to Improve Your Practice and Your Day

Keith H. Mullen

www.lucidchart.com

Lucidchart integrates with PowerPoint

Lucidchart Diagrams for PowerPoint

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