ABA SECTION OF REAL PROPERTY | REAL TRUST & ESTATE LAW

eReport

A Bi-Monthly Electronic Publication for Section Members

Trust and Estate News

December 2008

SIMPLE STRATEGIES FOR MAKING THE MOST OF THE IRC 2032 ALTERNATE VALUATION ELECTION IN AN ECONOMIC DOWNTURN

by KARIN PRANGLEY, ATTORNEY
Krasnow Saunders Cornblath LLP, Chicago, Illinois

The recent turbulence in the stock and real estate markets should remind estate planners of how important a tool the Internal Revenue Code Section 2032 estate tax alternative valuation election can be. In fact, it was in the midst of a similar (but, we hope, more severe) economic downturn that this estate tax provision has its roots. The predecessor to Section 2032 (Section 302(j)) was enacted in 1935 to help resolve the hardships decedents' estates experienced from the 1929 stock market crash and the Great Depression. 79 *Cong. Rec.* 14,632 (1935).

Given this state of affairs, it is timely that earlier this year, the Department of Treasury announced proposed regulations to Section 2032, described in the August eReport, at The Business Planning Group comments on Proposed Regulations 20.2031-1(f) concerning the estate tax alternate valuation of assets effected by post-death events other than market conditions. http://www.abanet.org/rppt/specialprojects/20.2032.pdf

As explained in the background to the Business Planning Group's comments, the proposed regulations attempt to clarify the use of the alternate valuation election and also to close a perceived loophole created by Kohler v. Commissioner, T.C. Memo 2006-152, nonacq. AOD 2008-001. REG-112196-07, Doc 2008-9091. The proposed regulations state that the alternate valuation election is available only to the extent that the value of the estate experiences a reduction in value because of market conditions.

If you have been one of the brave and have taken a look at your portfolio balance lately, you know that market conditions are bad, really bad. So now is the time to put this tool to its best use. As practitioners consider the alternate valuation election, they should keep in mind the following requirements to the election and often-overlooked points.

Section 2032 of the Internal Revenue Code allows the executor to value all property in a decedent's gross estate at a date later than the decedent's date of death if the executor makes the alternate valuation election. The election is, therefore, ideal for the estate of a decedent who died in mid-to-late 2007 or 2008 and is heavily invested in the real estate or stock markets or any related assets. Since the values of such estates have likely declined significantly post-death, these estates are prime candidates for the election.

If the executor makes the alternate valuation election, the alternate valuation date must be used on the federal estate tax return to value all assets comprising the gross estate. Treas. Reg. §20.2032-1(b). Alternate valuation can only be elected by the executor if the election decreases both the value of the gross estate and the combined total estate and GST tax due. Code §2032(c).

For purposes of the alternate valuation election, the relevant valuation date is 6 months after the decedent's date of death, or, if earlier, the date the property is first distributed, sold or exchanged or otherwise ceases to form a part of the decedent's estate. Code §2032(a); Treas. Reg. §20.2032-1(a). There are a few exceptions. If the value of the property is affected due to mere lapse of time, that change in value will be disregarded. Code §2032(a)(3). For example, if the decedent owned zero-coupon bonds that increased in value merely because of the accrual of 6 months of interest, then its value for estate tax purposes would be the date of death value. In addition, no additional deductions can be taken on the estate tax return if those deductions arise simply by virtue of the alternate valuation election. Code § 2032(b); Treas. Reg. §20.2032-1(g).

The executor can elect alternate valuation treatment by answering "yes" to the question "Do you elect alternate valuation?" on page two, Part 3, line 1 of the United States Estate (and Generation-Skipping Transfer) Tax Return, Form 706. If a Qualified Domestic Trust ("QDOT") is making the alternate valuation election, the Trustee of the QDOT should answer "yes" to the same question in Part II of the Form 706-QDT. For a decedent who is a non-resident not a citizen of the U.S., an alternate valuation election can be made and the mechanics of making the election are substantially the same. On the Form 706-NA, the executor should answer "yes" to the question posed on page 2, Schedule A and should include the alternate valuation date in column (c) of Schedule A.

Once made on the Form 706 (or 706-QDT or 706-NA, as the case may be), the alternate valuation election is irrevocable; provided, if the relevant Form 706 is filed early, the alternate valuation election can be revisited on a subsequently filed Form 706 that is filed on or before the initial due date for that tax return. Code §2032(d)(1); Treas. Reg. § 301.9100-6T.

The regulations also allow the decedent's executor to make a protective alternate valuation election. Treas. Reg. §20.2032-1(b)(2). Once the executor makes the protective election, it is also irrevocable. If the alternate valuation will not reduce the value of the gross estate and the combined GST and estate tax due, a protective election can be made to use alternate valuation should it later be determined that the estate meets the requirements for alternate valuation. If a protective alternate valuation is made, the executor must also calculate and include on the estate tax return the value of the property on the alternate valuation date. To make the protective alternate valuation election, the executor selects alternate valuation in part 3, line two of the

estate tax return and if there is no estate tax, the date of death values reflected on the return control. If subsequent events lead to a tax being due and the alternate valuation lowers the value of the estate and the tax due, the return would be amended and estate taxes re-determined from the alternate values listed on the return. The availability of the protective alternate valuation election should lead estate planners to consider the alternate valuation election for many non-taxable estates. Primarily because there is nothing to lose, only tax to save, by making the election – the election will only take effect if both the value of the gross estate and the total amount of GST and estate tax are reduced by the election.

In this declining market, where the value of many estates are worth less 6 months after the date of death than on the date of death, estate planners can potentially add value for their clients by encouraging the use of a protective alternate valuation election. The protective alternate valuation election would be beneficial for a non-taxable estate that is close to the taxable threshold (especially if discounted assets are involved) or if the decedent has made significant taxable gifts. The protective alternate valuation election would also be beneficial if the decedent's estate plan had no tax planning and the surviving spouse disclaimed specific assets equal to the decedent's estate tax exemption. In these cases, if the value of the disclaimed assets is increased upon audit, the protective alternate valuation election would take effect if the overall value of the estate and estate taxes are reduced. Of course, the executor has to file an estate tax return to make the protective election, which may be a problem if the estate is not taxable and the executor chooses not to file an estate tax return.

The protective alternate valuation election should also be strongly considered if the executor makes a special use valuation under Section 2032A of the Code (allowing certain real property to be valued at a reduced rate based on its actual use, rather than its highest and best use) in case the 2032A election is not granted and the highest and best use value of the property would bring the estate into taxable territory.

Estate planners can also potentially save estate taxes for their clients by making the alternate valuation election available in the estate of the first spouse to die. Because the Code and Regulations state that the election is not available unless there is tax payable, many estate planners assume the election is unavailable for the estate of a predeceasing spouse whose estate plan includes a self-adjusting zero-tax formula allocation between a marital and credit shelter trust. However, if the predeceasing spouse's property declines in value during the alternate valuation period, some creative estate planning could allow the alternate valuation election to be made on the predeceasing spouse's estate tax return. If the marital gift is structured in the form of a QTIP trust and the terms of the document so allow, a partial QTIP election can be made resulting in a small amount of estate tax due. In the alternative, the surviving spouse could make a qualified disclaimer of a portion of the property in the marital share and

slightly over-fund the credit shelter trust, making a small amount of estate tax payable. If the document is structured so that (i) the credit shelter trust is the residue of the estate (and the marital share is a formula amount), and (ii) the entire estate passes through the credit shelter trust, and then onto the trusts for the children, upon the death of the surviving spouse, then no special drafting is necessary. If the document provides for a formula, pre-residuary gift to the credit shelter trust and a marital residue, then in order to take advantage of this technique, the document should be revised to provide that any amounts disclaimed by the surviving spouse in the marital trust pass to the credit shelter trust.

If a tax is triggered through one of these two techniques and the value of the estate and total estate and GST tax due is reduced using the alternate valuation election, the estate now qualifies to use the election. Many clients are hesitant to pay any tax on the death of the first spouse, so it is important for estate planners to focus their clients on the "bang" they will receive for the tax "buck." The "bang" or benefits that a client can realize from the above technique could be substantial. The credit shelter trust would be maximized and the marital trust would be minimized, reducing estate taxes payable upon the death of the surviving spouse.

Consider the following illustration. Husband and wife have a joint taxable estate valued on the husband's date of death (assume husband dies first in the year 2008) at $10 million split equally between husband and wife, consisting entirely of shares in ABC Inc. -- 100 shares to be exact. Six months after husband's date of death, the shares in ABC (which are still held by husband's estate) decline in value by 5% due to a decline in the stock market. Husband and wife both have wills including a self-adjusting zero-tax formula allocation between a marital trust and a credit shelter trust, with all assets passing through to the credit shelter trust and on to the kids in separate trusts upon the death of the surviving spouse. Husband and wife have their entire estate tax exemption remaining. If the property is valued as of the date of death, the credit shelter trust will be funded with $2 million (20 shares in ABC). The marital trust receives the balance, worth $3 million, which is comprised of 30 shares in ABC. The alternate valuation election cannot be made because the use of the election does not lower the amount of tax due. If, however, wife disclaims a 1/10 share of ABC, which would result in a $5,000 estate tax liability (before alternate valuation is elected), the alternate valuation election would then be available. Using alternate valuation date values for the property in husband's estate, $2,004,750 (approximately 21.1 shares of ABC) would be distributed to the credit shelter trust, and approximately $2.74 million would be distributed to the marital trust (approximately 28.85 shares of ABC). The key benefit to the disclaimer is that more value is included in the credit shelter trust and less (approximately $260,000 less) value is included in the marital trust, which will be taxed in the estate of the surviving spouse. In this example, the estate tax savings would be approximately

$130,000, less the $4,725 in taxes paid on the death of the first spouse to die. If the surviving spouse lived years longer and the property in each trust appreciates, the estate tax savings would be even more substantial.

In this market, the above example of a 5% decline in a stock price over the course of 6 months is not unrealistic—it is optimistic. For example, on April 3, 2008, the S&P 500 (valued as required for estate tax purposes, taking the average of the high and low for the day) was at 1,367.17. Six months later, on October 3, 2008, the S&P 500 was down almost 18% to 1,125.98.

For the estate planner, now more than ever, it is important to run the numbers and show your client the benefits involved in making the alternate valuation election. Many clients may be concerned about the added cost and hassle of obtaining an additional appraisal, or the time and burden of tracking down the value of assets that have already been distributed to heirs. But these relatively minor inconveniences can be easily, especially in down markets, outweighed by the tax savings realized by making the alternate valuation election.

Illinois Update: Illinois Now Requires Trusts, Estates And Other Pass-Through Entities To Withhold Nonresident Beneficiaries' Share Of Illinois Income Tax

by KARIN PRANGLEY, ATTORNEY
Krasnow Saunders Cornblath LLP, Chicago, Illinois

http://www.revenue.state.il.us/Publications/Bulletins/2009/FY-2009-02.pdf

Illinois joins the ranks of approximately a dozen other states by requiring trusts and other pass-through entities to directly pay a nonresident beneficiary's share of Illinois state income tax. The Illinois Department of Revenue recently announced in an Informational Bulletin that effective for tax years ending on or after December 31, 2008, pass-through entities (trusts, estates, S corporations, partnerships and LLCs taxed as partnerships) must make Illinois state income tax payments on the entity's Illinois business income on behalf of each nonresident shareholder, partner or beneficiary. The pass-through entity will then provide the nonresident beneficiary or owner with a K-1 reflecting the amount of Illinois tax paid. The beneficiary or owner does not need to file his or her own Illinois 1040 to reflect the tax paid by the pass-through entity.

The trust or other pass-through entity does not need to make Illinois income tax payments on behalf of nonresident beneficiaries or owners if (i) such persons are included in a composite tax return, or (ii) the beneficiary or owner is not an individual and the entity has documented that it will file a return itself and pay its share of Illinois income tax.

Note that the new law only requires withholding with respect to Illinois "business income." Business income is defined in Schedule NR IL-1040 (Instructions) as all income earned or received during the regular course of the taxpayer's trade or business, excluding (i) compensation, (ii) income clearly attributable to only one state other than Illinois[1], and income earned or received through activities totally unrelated to any business the taxpayer is conducting in more than one state. For pass-through entities that do not carry-out business in Illinois and do not have Illinois business income, this new law should not be relevant.

Trustees of trusts that have Illinois business income and Illinois nonresident beneficiaries should be mindful of this new tax withholding requirement and should evaluate liquidity and trust distributions to ensure that there are sufficient funds in the trust to pay this new Illinois tax liability.

[1] Although Schedule NR IL-1040 (Instructions) does not provide that income attributable only to Illinois is business income, a telephone interview with the Illinois Department of Revenue confirmed that it is.

Executive Summary of Notice 2008-63

Rana H. Salti

On July 11, 2008, the Internal Revenue Service issued Notice 2008-63, which includes the text of a proposed revenue ruling regarding private trust companies. The notice addresses the income, estate, gift and generation-skipping transfer tax consequences of the appointment of a private trust company created by family members as the trustee of trusts of which the family members are grantors or beneficiaries.

This notice has been anticipated anxiously since the IRS announced on January 3, 2005 that it would no longer consider private letter ruling requests regarding the tax implications of the appointment of private trust companies as trustees of family trusts until the IRS issued additional guidance.

The IRS specifically states that the tax consequences of using a private trust company should be no more restrictive than the tax consequences of using individual or institutional trustees.

Facts

Husband and wife created separate irrevocable trusts for each of their children and grandchildren. The children also created irrevocable trusts for their respective descendants. Each child or grandchild is the primary beneficiary of the trust established for that child or grandchild. Each trust provides the trustee with discretionary authority to distribute income and/or principal to the primary beneficiary of the trust during the primary beneficiary's lifetime. Each primary beneficiary has a testamentary power of appointment exercisable in favor of one or more family members or charitable organizations. The grantor or, if the grantor is not living, the primary beneficiary, may appoint a successor trustee other than himself or herself if there is a vacancy in the office of trustee. In addition, each trust will terminate no later than 21 years after the death of the last to die of certain designated individuals. The notice describes two situations, depending upon whether the applicable state has enacted a statute governing private trust companies.

Situation 1: The private trust company ("PTC") is formed under the laws of a state that has enacted a private trust company statute. The statute provides as follows:

(1) Any private trust company formed under the statute must create a discretionary distribution committee ("DDC") and delegate to the DDC

the exclusive authority to make all decisions regarding discretionary distributions from each trust for which it serves as trustee.

(2) No member of the DDC may participate in the activities of the DDC with regard to any trust of which either the DDC member or his or her spouse is a grantor or beneficiary.

(3) In addition, a DDC member may not participate in the activities of the DDC with respect to any trust with a beneficiary to whom that DDC member or his or her spouse owes a legal obligation of support.

(4) Only officers and managers of the PTC may participate in decisions regarding personnel of the PTC, including the hiring, discharge, promotion, and compensation of employees.

(5) Neither the statute nor the PTC's governing documents may override a more restrictive provision in the trust instrument of a trust for which the PTC is acting as trustee.

(6) No family member may enter into any reciprocal agreement regarding discretionary distributions from any trust for which the PTC is serving as trustee.

The family formed a PTC consistent with the statute. The PTC is wholly-owned by the family. The PTC's governing documents do not restrict who may serve on the DDC. Some of the family members serve as officers and members of the board of directors of the PTC. These family members also serve on the DDC. One family member is a manager and employee of the PTC. Other family members own shares of the PTC but are not officers, directors or DDC members. One family member is a manager and employee of PTC. Following the resignation of a corporate trustee, the PTC was appointed as successor trustee of three irrevocable trusts. In addition, the husband created three additional irrevocable trusts (the "2008 Trusts") for the primary benefit of each of his three children and each child's descendants. Unlike the other irrevocable trusts described above, the 2008 Trusts provide that the trustee has discretionary authority to distribute income and/or principal to any one or more beneficiaries during the beneficiary's life. The husband named the PTC as the initial trustee of the trusts.

Situation 2: The PTC was formed in a state without a statute governing private trust companies, but the PTC's governing documents include provisions similar to the six items [(1) to (6)]

outlined above with respect to Situation 1. In addition, the PTC's governing documents also provide for the creation of an Amendment Committee, a majority of whose members must always be individuals who are neither family members nor persons related or subordinate to any shareholder of PTC. The Amendment Committee, by majority vote, has the sole authority to make any changes to PTC's governing documents regarding the creation, function, or membership of the DDC or Amendment Committee, the provisions delegating exclusive authority regarding personnel decisions to the officers and managers, and the prohibition of reciprocal agreements. The initial three members of the Amendment Committee are the husband and two non-family members. The two non-family members are not employed by the PTC and are not otherwise related or subordinate to any family member. Like Situation 1 above, some of the family members serve as officers and members of the board of directors of the PTC. These family members also serve on the DDC. Other family members own shares of the PTC but are not officers, directors or DDC members. One family member is a manager and employee of PTC.

Like Situation 1 above, following the resignation of a corporate trustee, the PTC was named as the successor trustee of each trust. In addition, the husband created three additional irrevocable trusts (the "2008 Trusts") for the primary benefit of each of his three children and each child's descendants. Like the 2008 Trusts in Situation 1 above, the 2008 Trusts provide that the trustee has discretionary authority to distribute income and/or principal to any one or more beneficiaries during the beneficiary's life. The husband named the PTC as the initial trustee of the trusts.

Conclusion 1: Trust Assets Not Included in Grantor's Gross Estate Under Sections 2036(a) or 2038(a).

Situation 1: The notice concludes that the value of the trust assets will not be included in any gross estate of a family member under § 2036(a) or § 2038(a), for the following reasons:

(1) All distribution decisions are made by the DDC, and no family member serving on the DDC may participate in making discretionary distribution decisions with respect to any trust of which that person or his or her spouse is either a grantor or beneficiary or with respect to any trust for someone to whom the family member owes any obligation of support.

(2) No PTC shareholder may change the provisions governing the DDC. As a result, no family member, either alone or with any other person, has any right or power described in § 2036(a) or § 2038(a) with respect to a trust solely by reason of PTC's service as trustee or by reason of the family

> member's ownership of or relationship with the PTC. Further, family members may not insert themselves into the roles of having any such powers.

As a result, the trust assets will not be included in the gross estate of any family member by reason of that person's service as an officer, director, member of the DDC, shareholder or employee of the PTC.

Situation 2: Unlike Situation 1, the state in Situation 2 does not have a statute restricting the ability of the private trust company's shareholders to change the applicable provisions governing the DDC. The family members in Situation 2 who are PTC shareholders may amend the PTC's governing documents. However, only the Amendment Committee may amend the provisions related to the DDC and the Amendment Committee. Accordingly, no family member is deemed to have a power to change the governing provisions regarding the DDC that would result in the inclusion of any part of the trust in the family member's gross estate. As a result, no portion of the trust should be includible in the grantor's gross estate under § 2036(a) or § 2038(a) by reason of PTC's service as trustee, the grantor's interest in PTC, or a grantor's service as an officer, director, manager, employee, or as a member of the DDC or the Amendment Committee.

Conclusion 2: Trust Assets Not Included in Beneficiary's Gross Estate Under Section 2041.

Situation 1: Under State 1's statute, the PTC's powers to make discretionary distributions are delegated exclusively to the DDC, and no beneficiary who is a DDC member is permitted to participate in discretionary distribution decisions with respect to a trust in which that beneficiary has a beneficial interest, including a trust held for the benefit of someone to which the beneficiary owes a legal obligation of support. In additional, family members are prohibited from entering into reciprocal arrangements designed to affect distribution decisions. The family members serving as officers, directors, and members of PTC's DDC do not have the unrestricted power to distribute trust assets to themselves as contemplated by § 2041. In addition, no beneficiary will be deemed to have a general power of appointment by participating in the daily activities of the PTC.

Situation 2: PTC's governing documents preclude a beneficiary from having the power as a member of the DDC to affect the beneficial enjoyment of property as described in § 2041. In addition, family members are prohibited from entering into reciprocal arrangements. As in Situation 1, the family members serving as officers, directors, and members of PTC's DDC do not have the unrestricted power to distribute trust assets to themselves as contemplated by § 2041. In addition, no beneficiary will be deemed to have a general power of appointment by

participating in the daily activities of the PTC. For reasons discussed in Conclusion 1 above, a beneficiary will not be deemed to have a general power of appointment under § 2041 as a result of the beneficiary's service on the Amendment Committee.

Conclusion 3: Grantor's Transfer to Trusts Constitute Completed Gifts.

Situations 1 and 2: In both Situations 1 and 2, no member of the DDC may participate in the activities of the DDC with regard to any trust of which that DDC member or his spouse is a grantor or any trust of which that DDC member or his or her spouse is a beneficiary. In addition, family members are prohibiting from entering into reciprocal agreements. The husband, as grantor of the 2008 Trusts, does not have the power to change the interests of the beneficiaries of the 2008 Trusts. Also, the husband is not considered to hold a power exercisable by him in conjunction with any other person not having a substantial adverse interest in the disposition of the transferred property or the property's income merely because of the husband's membership on the DDC. Thus, the husband's transfers to the 2008 Trusts will be deemed completed gifts. Also, because no member of the DDC may participate in the activities of the DDC with regard to any trust to which that DDC member or his spouse is a grantor or any trust of which that DDC member or his or her spouse is a beneficiary, distributions of income and principal from a trust of which the PTC is the trustee will not be deemed to be a gift by any member of the DDC.

Conclusion 4: GST Status of Trust Should Not Be Affected.

Situations 1 and 2: In both Situations 1 and 2, the change in trustee will not subject the value of the trust corpus to tax under Chapter 11 or 12, and the modification is an administrative change that does not shift a beneficial interest in a trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification. In addition, each trust will terminate no later than 21 years after the death of the last to die of certain designated individuals. As a result, appointing the PTC as trustee of the trusts does not affect the inclusion ratio of a trust subject to Chapter 13.

Conclusion 5: Grantor or Beneficiary Should Not Be Treated as Owner of Trust.

Situations 1 and 2: The provisions governing the DDC and, with respect to Situation 1, the state statute render the identity of the trustee irrelevant to the determination of whether any person is treated as an owner of a trust under §§ 675, 677, or 678. The circumstances regarding the operation of the PTC, the DDC, and the family trusts for which the PTC is acting as trustee will determine whether any grantor will be treated as the owner of any portion of the trusts under § 675, and this determination will be a question of fact. Accordingly, the appointment and service

of the trustee does not affect whether the grantor or any other person will be treated as the owner of a trust, and none of the grantors or beneficiaries of the family trusts for which the PTC is acting as trustee will be treated as an owner of the trusts under §§ 673, 675, 676, 677, or 678 solely by reason of their ownership or management of, or employment by, the PTC. Whether a grantor is treated as an owner of any portion of a trust under § 674 will depend upon the particular powers of the trustee and the proportion of the DDC members with authority to act with regard to that trust who are related or subordinate to the grantor. The ownership of voting stock of PTC is deemed to be not significant under § 672(c).

Comments to Notice.

Comments to the notice were due by November 4, 2008. Several professional organizations and law firms prepared comments to the notice.

Rana H. Salti,
Counsel and Trust Officer
Kinship Trust Company LLC
rana.salti@kinshiptrustco.com

AMT CONSEQUENCES OF TRUST EXPENSES THAT ARE SUBJECT TO THE 2% FLOOR UNDER SECTION 67

By T. Randolph Harris

A great deal of attention has been paid to whether or not particular trust expenses are subject to the 2% deductibility floor. However, little attention has been paid to the AMT consequences of such characterization.

Section 67(e) of the Code provides in part that "the deduction for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable in arriving at adjusted gross income." Although there is much controversy over exactly what expenses are described by section 67(e), the focus here is on the consequences of not being described by section 67(e). Let us assume that a non-grantor trust has a pure investment advisory expense of $100,000, and that under the *Knight* case that expense is not described in section 67(e). What is the effect of "flunking" section 67(e)?

Before turning to section 67(a) or 67(b), we must first look to section 63(d), which defines "itemized deductions" as "the deductions allowable under this chapter other than – (1) the deductions allowable in arriving at adjusted gross income, and (2) the deduction for personal exemptions provided by section 151." Thus, because our investment advisory expense "flunks" section 67(e), it is deemed an "itemized deduction."

Turning to section 67(b), we learn that the term “miscellaneous itemized deductions” refers to all “itemized deductions” other than the twelve specific deductions listed in section 67(b), which does not include investment advisory expenses (which are primarily deductible under section 212). Now that our investment advisory expense is categorized as a “miscellaneous itemized deduction,” it is subject to the 2% floor contained in section 67(a). The negative consequences of being subject to the 2% floor depend entirely on the other elements of the trust’s tax return for the year. For example, if the trust has $2,000,000 of adjusted gross income for the year and no other miscellaneous itemized deductions, our $100,000 investment advisory expense will only be allowed to the extent it exceeds $40,000. Thus, section 67(a) costs the trust $40,000 of deductions, or roughly $15,000 of federal tax. On the hand, if the trust has adjusted gross income of only $100,000 (if, for example, a $10,000,000 trust had flat investment results but still had to pay a 1% investment management fee), section 67(a) has no significant negative tax effect for the year.

The story does not end at section 67(a). Although many trust and estate lawyers do not understand the complexities of the alternative minimum tax, most of us are at least aware that section 55 requires the computation of “alternative minimum taxable income.” If the alternative minimum taxable income exceeds $22,500 (for an estate or trust), a tax rate of 26% - 28% is applied to the excess to compute the tentative minimum tax, and if that exceeds the regular tax, the excess is the AMT.

In computing alternative minimum taxable income, section 56(b) provides (among many other adjustments) that "No deduction shall be allowed – (i) for any miscellaneous deduction (as defined in section 67(b))." Thus, when an expense "flunks" section 67(e), it also becomes non-deductible for purposes of computing AMT.

In the case of the trust with AGI of $2,000,000 and no miscellaneous itemized deductions other than the $100,000 investment advisory fee, there will ordinarily be no AMT consequences. However in the other scenario, where the trust has only $100,000 of AGI, the loss for AMTI purposes of the $100,000 investment advisory fee deduction will cause the trust to have alternative minimum taxable income of $100,000, and after reduction for the $22,500 exemption, the 26% tentative minimum tax is roughly $20,000. Because the regular tax would have been close to zero, the trust owes AMT of about $20,000.

Practitioners should be aware that making distributions to beneficiaries does not avoid these potential negative consequences. Although the beneficiary will not receive any taxable income if the trust has $100,000 of gross income and $100,000 of deductions, the beneficiary will be required to reduce his or her deductions for AMT purposes by the $100,000 miscellaneous itemized deduction that is being passed through.

In short, in evaluating the tax consequences of a particular expense "flunking" section 67(e), it is necessary to look beyond the effect of the 2% floor

pursuant to section 67(a), and analyze whether there will also be nasty AMT consequences.

American Bar Association Section of Real Property, Trust and Estate Law
2008 Fall Section Meeting

"Hot Topics in Trusts & Estates: Bioethics"
By Professor Kristine S. Knaplund, Professor of Law, Pepperdine University School of Law and Co-Chair, ABA Committee on Bioethics

On November 4, 2008, voters in five states cast ballots on six initiatives relating to the field of bioethics.

Three measures passed:

Michigan Proposition 2: Passed 53% to 47% to permit embryonic stem cell research

Michigan Coalition for Compassionate Care Initiative: Passed 63% to 37% to allow the medical use of marijuana

Washington Initiative 1000: Passed 58% to 42% to allow doctor-assisted suicide

Three measures failed:

California Proposition 4: Failed 55% to 45%: would have imposed a requirement for parental notification and a waiting period before a minor obtained an abortion.

Colorado Amendment 48: Failed 73% to 27%: would have defined a "person" as including a human being from the moment of fertilization

South Dakota Measure 11: Failed 55% to 45%: would have banned all abortions except for those performed because of rape or incest, or to protect the mother's health.

Source: http://ballotpedia.org

Michigan Proposition 2, which passed by a vote of 53% to 47%, now allows Michigan researchers to use embryos left over from in vitro fertilization to create embryonic stem-cine lines for disease research, as permitted by federal law. The measure repeals laws that had made it illegal to donate an embryo to science.

Some states have gone further than the Michigan law to fund such research. New Jersey, in May 2004, provided $9.5 million for research. California voters passed Proposition 71 in November 2004 pledging $295 million per year for ten years for stem cell research. Law suits filed in California delayed any such funding until the California Court of Appeal Court upheld the constitutionality of Proposition 71 in February 2007, holding that it did not violate California's single-subject rule, and also complied with the requirement that state funds be administered by entities within the state's exclusive management and control. *California Family Bioethics Council v. Independent Citizens Oversight Committee*, 147 Cal. App. 4th 1319, 55 Cal. Rptr. 3d 272 (2007); *review denied*, 2007 Cal. LEXIS 5147 (May 16, 2007). Other states have provided funding, including Connecticut in June 2005 ($20M); Illinois in July 2005 created an institute to award grants for stem cell research.

Michigan Question 1, the Michigan Coalition for Compassionate Care Initiative, which passed by a vote of 63% to 37%, allows terminally ill and seriously ill patients to use marijuana with their doctor's approval. The law also allows these patients and their caregivers to cultivate marijuana for medical use. Similar measures have passed in other states, including Alaska in 1998 for those with a "debilitating medical condition," and California Proposition 215 in 1996. South Dakota voters rejected Initiated Measure 4, similar to Alaska's measure, in 2006.

Washington Initiative 1000, the "Death With Dignity" Act, passed by a vote of 58% to 42%. The Act is based largely on Oregon's 1994 statute, and permits terminally ill, competent adult Washington residents who are medically predicted to die within six months, to request and self-administer lethal medication prescribed by a physician. The Act requires three requests by the patient (one written and two oral); it also requires two physicians to diagnose the patient and determine that the patient is competent.

Results of the Oregon statute may prove instructive for the new Washington law. Oregon posts reports of those who are prescribed lethal medication under its Death With Dignity Act. For example, during 2007, of the 85 prescriptions for lethal medications that were written during the year, 46 patients actually took the medications; another 26 died of their underlying disease, and 13 were still alive at the end of the year.

See http://www.oregon.gov/DHS/ph/pas/

A total of 341 Oregon patients had died after taking a legal dose of medication prescribed under the Oregon Act from 1998 to 2007. *Id.*

Financial Action Task Force

Groupe d'action financière

RBA GUIDANCE FOR LEGAL PROFESSIONALS

23 October 2008

TABLE OF CONTENTS

SECTION ONE: USING THE GUIDANCE

PURPOSE OF THE RISK-BASED APPROACH

Chapter One: Background and Context

1. In June 2007, the FATF adopted Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing: High Level Principles and Procedures, which includes guidance for public authorities and guidance for financial institutions. This was the culmination of extensive consultation between private and public sector members of an Electronic Advisory Group (EAG) established by the FATF.

2. In addition to financial institutions, the FATF Recommendations also cover a number of designated non-financial businesses and professions (DNFBPs). At its June 2007 meeting, the FATF's Working Group on Evaluation and Implementation (WGEI) endorsed a proposal to convene a meeting of the representatives from the DNFBPs to assess the possibility of developing Guidance on the risk-based approach for their sectors, using the same structure and style as the completed Guidance for financial institutions.

3. This meeting was held in September 2007 and was attended by members of organisations which represent lawyers, notaries, trust and company service providers (TCSPs), accountants, casinos, real estate agents and dealers in precious metals and dealers in precious stones. This private sector group expressed an interest in contributing to FATF Guidance on implementing a risk-based approach for their sectors. The Guidance for the DNFBPs would follow the principles of the risk-based approach already established by FATF, and would highlight risk factors specific to the DNFBPs, as well as suggest mitigation strategies that fit with the particular activities and businesses of the DNFBPs. The FATF established another EAG to facilitate the work.

4. The private sector group met again in December 2007 and was joined by a number of specialist public sector members. Separate working groups comprising public and private sectors members were established, and private sector chairs were appointed.

5. The EAG continued work until this Guidance for legal professionals was presented to the WGEI. After further international consultation with both public and private sectors, the FATF adopted this Guidance at its October 2008 Plenary. Guidance for each of the other DNFBP sectors is being published separately.

<u>Purpose of the Guidance</u>

6. The purpose of this Guidance is to:

- Support the development of a common understanding of what the risk-based approach involves.
- Outline the high-level principles involved in applying the risk-based approach.
- Indicate good practice in the design and implementation of an effective risk-based approach.

7. However, it should be noted that applying a risk-based approach is not mandatory. A properly applied risk-based approach does not necessarily mean a reduced burden, although it should result in a more cost effective use of resources. For some countries, applying a rules-based system might be more appropriate. Countries[1] will need to make their own determinations on whether to apply a risk-based approach, based on their specific money laundering/terrorist financing risks, size and nature of the DNFBP activities, and other relevant information. The issue of timing is also relevant for countries that may have applied anti-money laundering/counter-terrorist financing (AML/CFT) measures to DNFBPs, but where it is uncertain whether the DNFBPs have sufficient experience to implement and apply an effective risk-based approach.

Target Audience, Status and Content of the Guidance

8. This Guidance has been prepared for, and in relation to, legal professionals.[2] The legal professionals sector includes various professions, including lawyers and notaries, and in some countries there are also different categories of lawyers *e.g.* barristers and solicitors. Many legal professionals are required to comply with specific legislation and regulation and rules and regulations enacted or adopted by professional associations or other self regulatory organisations (SROs). The activities of legal professionals are very diverse, as are the legal and professional obligations with which they are required to comply. The specifics of an individual legal professional's and/or a firm or other collection of legal professionals' particular risk-based processes should accordingly be determined based on the activities undertaken by the legal professional, the ethical and existing supervisory structure for legal professionals and the susceptibility of a legal professional's activities (both generally and particularly) to money laundering and terrorist financing.

9. Legal professionals provide a range of services and activities that differ vastly, such as in their methods of delivery and in the depth and duration of the relationships formed with clients. This Guidance is written at a high level to take into account the differing practices of legal professionals in different countries, and the different levels and forms of supervision or monitoring that may apply. It is not intended as a template for national legislation imposing obligations on legal professionals or SROs. Each country and its national authorities should aim to establish an active dialogue with its legal professionals and other DNFBP sectors that will be mutually beneficial in establishing effective systems to combat money laundering and terrorist financing.

10. The following general observations about legal professionals should help inform the approach. Consideration should also be given to the particular activities performed by legal professionals on a national, provincial, or local basis. Because legal professionals typically refer to those benefiting from their services as "clients" rather than "customers", that term is thus generally used throughout this paper, except where specific terms of art such as "customer due diligence" and "know your customer" are used (in such cases a customer can be equated to a client).

11. For purposes of this Guidance, legal professionals include both lawyers and notaries.

- Lawyers are members of a regulated profession and are bound by their specific professional rules and regulations. Their work is fundamental to promoting adherence to the rule of law in the countries in which they practice. Lawyers hold a unique position in society by providing

[1] All references in the FATF Recommendations and in this document to country or countries apply equally to territories or jurisdictions.

[2] This refers to sole legal practitioners and partners or employed legal professionals within professional firms. It is not meant to refer to "internal" (*i.e.* in-house) professionals that are employees of other types of businesses, nor to legal professionals working for government agencies, who may already be subject to separate measures that would combat money laundering and terrorist financing. See FATF 40 Recommendations Glossary, definition of "Designated Non-Financial Businesses and Professions" (e).

access to law and justice for individuals and entities, assisting members of society to understand their increasingly complex legal rights and obligations, and assisting clients to comply with the law. Lawyers have their own professional and ethical codes of conduct by which they are regulated. Breaches of the obligations imposed upon them can result in a variety of sanctions, including disciplinary and criminal penalties. The provisions contained in this Guidance, when applied by each country, are subject to professional secrecy and legal professional privilege. As is recognised by the interpretative note to the FATF Recommendation 16, the matters that would fall under legal professional privilege or professional secrecy and that may affect any obligations with regard to money laundering and terrorist financing are determined by each country. Likewise, ethical rules that impose obligations, duties, and responsibilities on legal professionals vary by country. The legal professionals' counseling and advisory role, especially in an increasing regional and global marketplace, does not generally involve a cash handling function.

- Both civil and common law countries have notaries, but the roles of civil and common law notaries differ. Common law mainly differs from civil law in that precedents can be drawn from case law, while in civil systems codified rules are applied by judges to the cases before them. In some common law countries, the common law notary public is a qualified, experienced practitioner, trained in the drafting and execution of legal documents. In other common law countries, the notary public is a public servant appointed by a governmental body to witness the signing of important documents (such as deeds and mortgages) and administer oaths. Known only in civil law jurisdictions, civil law notaries are both members of an autonomous legal profession – although regulated by the law – and qualified public officials, as they are appointed by the State through a selective public contest among law graduates. Civil law notaries, who are bound by an obligation of impartiality with respect to both parties, must be regarded, in matters of real property (conveyancing), family law, inheritance and corporate legal services as practising non-contentious activities**.** They act as gatekeepers by drafting, ensuring the legality and certainty of the instruments and the authenticity of signatures presented to them; providing as well a public fiduciary function by performing the role of a trusted third party . Civil law notaries are obliged by law not to detach themselves from the core of the relationship, therefore making them responsible for all aspects of the deed. For this reason, civil law notaries are assigned functions of a public nature as part of their legal assignments. In civil law jurisdictions, notarial written documents are particular means of evidence, unlike in the common law systems, which are based on the free evidence of witnesses in court: special supreme State powers are devolved to civil law notaries and they can therefore assign "public authority" to each deed they perform. Thereby the civil law notary's deed has a special effectiveness in a trial, whereby it is a means of peremptory binding evidence; furthermore, it is as judicially enforceable as a judgement; if it complies with the law, it can be registered on a public registry. Owing to these characteristics, civil law notaries play a different role in comparison to the services provided by other legal professionals. This Guidance does not cover those common law notaries who perform merely administrative acts such as witnessing or authenticating documents, as these acts are not specified activities.

12. Recommendation 12 mandates that the requirements for customer due diligence requirements (CDD), record-keeping, and paying attention to all complex, unusual large transactions set out in Recommendations 5, 6, and 8 to 11 apply to DNFBPs in certain circumstances. Recommendation 12 applies to legal professionals when they prepare for and carry out certain specified activities:

- Buying and selling of real estate.
- Managing of client money, securities or other assets.
- Management of bank, savings or securities accounts.

- Organisation of contributions for the creation, operation or management of companies.

- Creation, operation or management of legal persons or arrangements, and buying and selling of business entities.

This Guidance has been prepared to assist legal professionals in those situations. Unless legal advice and representation consists of preparing for or carrying out transactions relating to these specified activities, it is not subject to the FATF Recommendations. The Recommendations would thus not cover, for example, an initial meeting before any preparatory work is carried out, or the usual level of advice given at legal aid or other "walk up" clinics.

13. It is possible that more than one legal professional will be preparing for or carrying out a transaction, in which case they will all need to observe the applicable CDD and record-keeping obligations. However, several legal professionals may be involved in a transaction for a specified activity but not all are preparing for or carrying out the overall transaction. In that situation, those legal professionals providing advice or services (*e.g.* a local law validity opinion) peripheral to the overall transaction who are not preparing for or carrying out the transaction may not be required to observe the applicable CDD and record-keeping obligations.

14. Recommendation 16 requires that FATF Recommendations 13 to 15 regarding reporting of suspicious transactions and AMLCFT controls, and Recommendation 21 regarding measures to be taken with respect to countries that do not or insufficiently comply with the FATF Recommendations, apply to DNFBPs subject to the certain qualifications. Specifically, Recommendation 16 applies to legal professionals when they engage in a financial transaction on behalf of a client, in relation to the activities referred to in Recommendation 12. Recommendation 16, however, provides that legal professionals are not required to report their suspicions if the relevant information was obtained in circumstances where they are subject to professional secrecy or legal professional privilege. The lawyer-client relationship is protected by law, regulations, and rules, and codes of conduct (such as legal professional privilege) in many countries, including in some countries by constitutional provisions. This is recognised by the Interpretative Note to Recommendation 16.

15. The wider audience for this Guidance includes countries, regulators, and self-regulatory organisations (SROs), which are considering how to apply AML/CFT measures to legal professionals. Countries need to identify the most appropriate regime, tailored to address individual country risks, which takes into consideration the activities and professional and ethical codes of conduct of legal professionals in their countries. This regime should recognise the differences between the DNFBP sectors, as well as the differences between the DNFBPs (particularly legal professionals) and financial institutions. However, this Guidance does not override the purview of national authorities. The manner in which legal professionals, SROs, or other supervisory bodies approach their responsibilities under a risk-based CDD system must necessarily be informed by and conform with the existing legal and oversight framework within each country's jurisdiction.

- To the extent a country has adopted a risk-based approach regime, the legal professionals practising in that country should refer to that country's guidance for that regime.

- This Guidance does not supplant specific professional guidance issued by designated competent authorities or SROs in a particular country, and does not constitute a legal interpretation of AML or CFT obligations of legal professionals, and should not be relied on by legal professionals or the judiciary in determining whether a legal professional has complied with his or her AML or CFT obligations.

16. The provisions in this Guidance are subject to applicable professional secrecy, legal professional privilege or rules of professional conduct, which are determined by each country.

Chapter Two: The Risk-Based Approach – Purpose, Benefits and Challenges

The purpose of the Risk-Based Approach

17. The FATF Recommendations contain language that permits countries to some degree to adopt a risk-based approach to combating money laundering and terrorist financing. That language also authorises countries to permit DNFBPs to use a risk-based approach in applying certain of their AML and CFT obligations.

18. By adopting a risk-based approach, it is possible to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified. This will allow resources to be allocated in the most efficient ways. The principle is that resources should be directed in accordance with priorities so that the greatest risks receive the highest attention. The alternative approaches are that resources are either applied evenly, or that resources are targeted, but on the basis of factors other than risk. This can inadvertently lead to a 'tick box' approach with the focus on meeting regulatory requirements rather than on combating money laundering or terrorist financing efficiently and effectively.

19. A number of the DNFBP sectors, including legal professionals, are already subject to regulatory or professional requirements (including as promulgated by SROs) that complement AML/CFT measures. For example, by virtue of their professional codes of conduct, many lawyers are already subject to an obligation to identify their clients (*e.g.* to check for conflict of interest) and the substance of the matter submitted to them by such clients, in order to appreciate the consequences that their advice may have. If a lawyer provides legal advice to a client that helps the client commit an offence, that lawyer may, depending on the lawyer's state of knowledge, become an accomplice to the offence. This Guidance must be considered in the context of these professional and ethical codes of conduct. Where possible, it will be beneficial for legal professionals (and relevant authorities and SROs) to devise their AML/CFT policies and procedures in a way that harmonises with other regulatory or professional requirements. A risk-based AML/CFT regime should not impede free access to the services provided by legal professionals for legitimate purposes, but should create barriers to those who seek to misuse these services.

20. A risk analysis must be performed to determine where the money laundering and terrorist financing risks are the greatest. Countries will need to identify the main vulnerabilities and address them accordingly. Legal professionals will need this assistance and information to help them to identify higher risk clients and services, including delivery channels, and geographical locations. These are not static assessments. They will change over time, depending on how circumstances develop, and how threats evolve.

21. The strategies to manage and mitigate money laundering and terrorist financing are typically aimed at preventing the activity from occurring through a mixture of deterrence (*e.g.* appropriate CDD measures), detection (*e.g.* monitoring and suspicious transaction reporting), and record-keeping so as to facilitate investigations.

22. Proportionate procedures should be designed based on assessed risk. Higher risk areas should be subject to enhanced procedures; this would include measures such as enhanced CDD checks and enhanced transaction monitoring. It also follows that in instances where risks are low, simplified, modified or reduced controls may be applied.

23. There are no universally accepted methodologies that prescribe the nature and extent of a risk-based approach. However, an effective risk-based approach does involve identifying and categorising money laundering and terrorist financing risks and establishing reasonable controls based on risks identified.

24. An effective risk-based approach will allow legal professionals to exercise reasonable business and professional judgement with respect to clients. Application of a reasoned and well-articulated risk-based approach will justify the judgements made with regard to managing potential money laundering and terrorist financing risks. A risk-based approach should not be designed to prohibit or impede legal professionals from continuing with legitimate practice – especially given their role in society and the proper functioning of the justice system - or from finding innovative ways to diversify or expand their practices.

25. Regardless of the strength and effectiveness of AML/CFT controls, criminals will continue to attempt to move illicit funds undetected and will, from time to time, succeed. Criminals are more likely to target the DNFBP sectors, including legal professionals, if other routes become more difficult. For this reason, DNFBPs may be more or less vulnerable depending on the effectiveness of the AML/CFT procedures applied in other sectors. A risk-based approach allows DNFBPs, including legal professionals, to more efficiently and effectively adjust and adapt as new money laundering and terrorist financing methods are identified.

26. A reasonably designed and effectively implemented risk-based approach can provide an appropriate and effective control structure to manage identifiable money laundering and terrorist financing risks. However, it must be recognised that any reasonably applied controls, including controls implemented as a result of a reasonably designed and effectively implemented risk-based approach, will not identify and detect all instances of money laundering or terrorist financing. Therefore, designated competent authorities, SROs, law enforcement, and judicial authorities must take into account and give due consideration to a well reasoned risk-based approach. When there is a failure to implement an adequately designed risk-based approach or failure of a risk-based programme that was not adequate in its design, designated competent authorities, SROs, law enforcement or judicial authorities should take action as necessary and appropriate.

Potential Benefits and Challenges of the Risk-Based Approach

Benefits

27. The adoption of a risk-based approach to combating money laundering and terrorist financing can yield benefits for all parties, including the public. Applied effectively, the approach should allow a more efficient and effective use of resources and minimise burdens on clients. Focusing on higher risk threats should mean that beneficial outcomes can be achieved more effectively.

28. For legal professionals, the risk-based approach allows the flexibility to approach AML/CFT obligations using specialist skills and responsibilities. This requires legal professionals to take a wide and objective view of their activities and clients.

29. Efforts to combat money laundering and terrorist financing should also be flexible in order to adapt as risks evolve. As such, legal professionals should use their judgement, knowledge and expertise to develop an appropriate risk-based approach for their particular organisation, structure and practice activities.

Challenges

30. The risk-based approach is not necessarily an easy option and is challenging to both public and private sector entities. Some challenges may be inherent to the use of the risk-based approach. Others may stem from the difficulties in making the transition to a risk-based system. A risk-based approach requires resources and expertise to gather and interpret information on risks, both at the country and institutional levels, to develop procedures and systems, and to train personnel. It further requires that sound and well-trained judgement be exercised in the design and implementation of procedures, and systems. It will certainly lead to a greater diversity in practice that should lead to innovations and improved compliance. However, it may also cause uncertainty regarding

expectations, difficulty in applying uniform regulatory treatment, and lack of understanding by clients regarding information required.

31. Implementing a risk-based approach requires that legal professionals have a sound understanding of the risks and are able to exercise sound judgement. This requires the building of expertise including for example, through training, recruitment, taking professional advice and 'learning by doing'. The process will always benefit from information sharing by designated competent authorities and SROs. The provision of good practice guidance is also valuable. Attempting to pursue a risk-based approach without sufficient expertise may lead to flawed judgements. Legal professionals may over-estimate risk, which could lead to wasteful use of resources, or they may under-estimate risk, thereby creating vulnerabilities. They, and (if applicable) their staff members, may be uncomfortable making risk-based judgements. This may lead to overly cautious decisions, or disproportionate time spent documenting the rationale behind a decision. This may also be true at various levels of management. However, in situations where management fails to recognise or underestimate the risks, a culture may develop that allows for inadequate resources to be devoted to compliance, leading to potentially significant compliance failures.

32. Designated competent authorities and SROs should place greater emphasis on whether legal professionals have an effective decision-making process with respect to risk management. Sample testing may be used or individual decisions reviewed as a means to test the effectiveness of a legal professional's overall risk management. Designated competent authorities and SROs should recognise that even though appropriate risk management structures and procedures are regularly updated, and the relevant policies, procedures, and processes are followed, decisions may still be made that are incorrect in light of additional information that was not reasonably available at the time.

33. In implementing the risk-based approach, legal professionals should be given the opportunity to make reasonable judgements for their particular services and activities. This may mean that no two legal professionals and no two firms are likely to adopt the same detailed practices. Such potential diversity of practice will require that designated competent authorities and SROs make greater effort to identify and disseminate guidelines on sound practice, and may pose challenges for staff working to monitor compliance. The existence of good practice guidance, continuing legal education, and supervisory training, industry studies and other materials will assist the designated competent authority or an SRO in determining whether a legal professional has made sound risk-based judgements.

34. Recommendation 25 requires adequate feedback to be provided to the financial sector and DNFBPs. Such feedback helps institutions, firms and businesses to more accurately assess the money laundering and terrorist financing risks and to adjust their risk programmes accordingly. This in turn makes the detection of suspicious activity more likely and improves the quality of any required suspicious transaction reports. As well as being an essential input to any assessment of country or sector wide risks, the promptness and content of such feedback is relevant to implementing an effective risk-based approach.

The potential benefits and potential challenges can be summarised as follows:

Potential Benefits:

- Better management of risks and cost-benefits
- Focus on real and identified threats
- Flexibility to adapt to risks that change over time

Potential Challenges:

- Identifying appropriate information to conduct a sound risk analysis
- Addressing short term transitional costs
- Greater need for more expert staff capable of making sound judgements. Regulatory response to potential diversity of practice.

Chapter Three: FATF and the Risk-Based Approach

35. The varying degrees of risk of money laundering or terrorist financing for particular types of DNFBPs, including legal professionals, or for particular types of clients, or transactions is an important consideration underlying the FATF Recommendations. According to the Recommendations, with regard to DNFBPs there are specific Recommendations where the degree of risk is an issue that a country either must take into account (if there is higher risk), or may take into account (if there is lower risk)**.**

36. The risk-based approach is either incorporated into the Recommendations (and the Methodology) in specific and limited ways in a number of Recommendations, or it is inherently part of or linked to those Recommendations. For instance, for DNFBPs, including legal professionals risk is addressed in three principal areas (a) Customer/client Due Diligence (*R.5, 6, 8 and 9*); (b) legal professionals and/or firms' internal control systems (*R.15*); and (c) the approach of oversight/monitoring of DNFBPs, including legal professionals (*R.24*).

Client Due Diligence (R. 5, 6, 8 and 9)

37. Risk is referred to in several forms:

a) Higher risk – Under Recommendation 5, a country must require its DNFBPs, including legal professionals, to perform enhanced due diligence for higher-risk clients, business relationships or transactions. Recommendation 6 (politically exposed persons) is an example of this principle and is considered to be a higher risk scenario requiring enhanced due diligence.

b) Lower risk – A country may also permit legal professionals to take lower risk into account in deciding the extent of the CDD measures they will take (see Methodology criteria 5.9). Legal professionals may thus reduce or simplify (but not avoid completely) the required measures.

c) Risk arising from innovation – Under Recommendation 8, a country must require legal professionals to give special attention to the risks arising from new or developing technologies that might favour anonymity.

d) Risk assessment mechanism – The FATF standards require that there be an adequate mechanism by which designated competent authorities or SROs assess or review the procedures adopted by legal professionals to determine the degree of risk and how they manage that risk, as well as to review the actual determinations themselves. This expectation applies to all areas where the risk-based approach applies. In addition, where the designated competent authorities or SROs have issued guidelines on a suitable approach to risk-based procedures, it will be important to establish that these have been followed. The Recommendations also recognise that country risk is a necessary component of any risk assessment mechanism (R.5 & R.9).

Internal control systems (R.15)

38. Under Recommendation 15, the development of "appropriate" internal policies, training and audit systems will need to include a specific, and ongoing, consideration of the potential money laundering and terrorist financing risks associated with clients, products and services, geographic areas of operation and so forth. The Interpretative Note to Recommendation 15 makes it clear that a country may allow legal professionals to have regards to the money laundering and terrorist financing risks, and to the size of the business, when determining the type and extent of measures required.

Regulation and oversight by designated competent authorities or SROs (R.24)

39. Countries should ensure that legal professionals are subject to effective systems for monitoring and ensuring compliance with AML/CFT requirements. In determining whether the system for monitoring and ensuring compliance is appropriate, regard may be had to the risk of money laundering or terrorist financing in a given business, *i.e.* if there is a low risk then reduced monitoring measures may be taken.

Applicability of the risk-based approach to terrorist financing

40. There are both similarities and differences in the application of a risk-based approach to terrorist financing and money laundering. They both require a process for identifying and assessing risk. However, the characteristics of terrorist financing make its detection difficult and the implementation of mitigation strategies may be challenging due to considerations such as the relatively low value of transactions involved in terrorist financing, or the fact that funds can be derived from legitimate as well as illicit sources.

41. Funds that are used to finance terrorist activities may be derived either from criminal activity or may be from legal sources, and the nature of the funding sources may vary according to the type of terrorist organisation. Where funds are derived from criminal activity, then traditional monitoring mechanisms that are used to identify money laundering may also be appropriate for terrorist financing, though the activity, which may be indicative of suspicion, may not be identified as or connected to terrorist financing. It should be noted that transactions associated with the financing of terrorism may be conducted in very small amounts, which in applying a risk-based approach could be the very transactions that are frequently considered to be of minimal risk with regard to money laundering. Where funds are from legal sources then it is even more difficult to determine if they could be used for terrorist purposes. In addition, the actions of terrorists may be overt and outwardly innocent in appearance, such as the purchase of materials and services to further their goals, with the only covert fact being the intended use of such materials and services purchased. Therefore, while terrorist funds may be derived from criminal activity as well as from legitimate sources, transactions related to terrorist financing may not exhibit the same traits as conventional money laundering. In all cases, however, legal professionals are not responsible for determining the type of underlying criminal activity or intended terrorist purpose.

42. The ability of legal professionals to detect and identify potential terrorist financing transactions without guidance on terrorist financing typologies or unless acting on specific intelligence provided by the authorities is significantly more challenging than is the case for potential money laundering and other suspicious activity. Detection efforts, absent specific national guidance and typologies, are likely to be based on monitoring that focuses on transactions with countries or geographic areas where terrorists are known to operate or on the other limited typologies available (many of which are indicative of the same techniques as are used for money laundering).

43. Specific individuals, organisations or countries may be the subject of terrorist financing sanctions, in a particular country. In such cases a listing of individuals, organisations or countries to which such sanctions apply and the obligations on legal professionals to comply with those sanctions are decided by individual countries and are not a function of risk. Legal professionals may commit a criminal offence if they undertake business with a listed individual, organisation or country, or its agent, in contravention of applicable sanctions.

44. For these reasons, this Guidance has not comprehensively addressed the application of a risk-based process to terrorist financing. It is clearly preferable that a risk-based approach be applied where reasonably practicable, but further consultation with key stakeholders is required to identify a more comprehensive set of indicators of the methods and techniques used for terrorist financing, which can then be factored into strategies to assess terrorist financing risks and devise measures to mitigate them. DNFBPs, including legal professionals, would then have an additional basis upon

40-44 and such subsequent consultations when they occur.

Limitations to the risk-based approach

45. There are circumstances in which the application of a risk-based approach will not apply, or may be limited. There are also circumstances in which the application of a risk-based approach may not apply to the initial stages of a requirement or process, but then will apply to subsequent stages. The limitations to the risk-based approach are usually the result of legal or regulatory requirements that mandate certain actions to be taken.

46. Requirements to freeze assets of identified individuals or entities, in countries where such requirements exist, are independent of any risk assessment. The requirement to freeze is absolute and cannot be impacted by a risk-based process. Similarly, while the identification of potential suspicious transactions can be advanced by a risk-based approach, in countries where such obligations exist, the reporting of such suspicious transactions, once identified, is not risk-based. (See paragraph 119.)

47. CDD comprises several components – Identification and verification of the identity of clients and of beneficial owners, obtaining information on the purposes and intended nature of the business relationships and conducting ongoing due diligence. Of these components, the identification and verification of identity of clients are requirements that must be completed regardless of the risk-based approach. However, in relation to all other CDD components, a reasonably implemented risk-based approach may allow for a determination of the extent and quantity of information required, and the mechanisms to be used to meet these minimum standards. Once this determination is made, the obligation to keep records and documents that have been obtained for due diligence purposes, as well as transaction records, is not dependent on risk levels.

48. Countries may allow legal professionals to apply reduced or simplified measures where the risk of money laundering or terrorist financing is lower. However, these reduced or simplified measures do not necessarily apply to all aspects of CDD. Where these exemptions are subject to certain conditions being met, it is necessary to verify that these conditions apply, and where the exemption applies under a certain threshold, measures should be in place to prevent transactions from being split artificially to avoid the threshold. Information beyond client identity, such as client location, may be needed to adequately assess risk. This will be an iterative process: the preliminary information obtained about a client should be sufficient to determine whether to go further, and in many cases client monitoring will provide additional information.

49. Some form of monitoring is required in order to detect unusual and hence possibly suspicious transactions. Even in the case of lower risk clients, monitoring is needed to verify that transactions match the initial low risk profile and if not, trigger a process for appropriately revising the client's risk rating. Equally, risks for some clients may only become evident once a relationship with a client has begun. This makes appropriate and reasonable monitoring of client transactions an essential component of a properly designed risk-based approach; however, within this context it should be understood that not all transactions or clients will be monitored in exactly the same way. Moreover, where there is an actual suspicion of money laundering or terrorist financing, this could be regarded as a higher risk scenario, and enhanced due diligence should be applied regardless of any threshold or exemption. Given the relationship between a legal professional and his/her client, the most effective form of ongoing monitoring will often be continued observance and awareness of a client's activities by the legal professional. This requires legal professionals to be alert to this basis of monitoring and for training of legal professionals to take this feature into account.

Distinguishing Risk-Based Monitoring and Risk-Based Policies and Processes

50. Risk-based policies and processes should be distinguished from risk-based monitoring by designated competent authorities or SROs. There is a general recognition within monitoring practice that resources should be allocated taking into account the risks posed by individual practices. The methodology adopted by the designated competent authorities or SROs to determine allocation of monitoring resources should cover the practice focus, the risk profile and the internal control environment, and should permit relevant comparisons between practices. Most fundamentally, such methodology needs to recognize that the relationship between the legal professional and the client is often an on-going one. The methodology used for determining the allocation of resources will need updating on an ongoing basis so as to reflect the nature, importance and scope of the risks to which individual practices are exposed. Consequently, this prioritisation should lead designated competent authorities or SROs to focus increased regulatory attention to legal professionals who engage in activities assessed to be of higher risk of money laundering or terrorist financing.

51. However, it should also be noted that the risk factors taken into account to prioritise the designated competent authorities or SROs' work will depend not only on the intrinsic risk associated with the activity undertaken, but also on the quality and effectiveness of the risk management systems put in place to address such risks.

52. Since designated competent authorities or SROs should have already assessed the quality of risk management controls applied by legal professionals, it is reasonable that their assessments of these controls be used, at least in part, to inform money laundering and terrorist financing risk assessments conducted by individual firms or businesses.

Summary box: A risk-based approach to countering money laundering and terrorist financing at the national level: key elements for success

- Legal professionals, designated competent authorities and/or SROs should have access to reliable and actionable information about the threats.
- There must be emphasis on cooperative arrangements among the policy makers, law enforcement, regulators, and the private sector.
- Authorities should publicly recognise that the risk-based approach will not eradicate all elements of risk.
- Authorities have a responsibility to establish an atmosphere in which legal professionals need not be afraid of regulatory sanctions where they have acted responsibly and implemented adequate internal systems and controls.
- Designated competent authorities' and/or SROs' supervisory staff must be well-trained in the risk-based approach, both as applied by designated competent authorities/SROs and by legal professionals.

SECTION TWO: GUIDANCE FOR PUBLIC AUTHORITIES

Chapter One: High-level principles for creating a risk-based approach

53. The application of a risk-based approach to countering money laundering and the financing of terrorism will allow designated competent authorities or SROs and legal professionals to use their resources most effectively. This chapter sets out five high-level principles that should be considered by countries when designing a risk-based approach applicable to legal professionals. They could be considered as setting out a broad framework of good practice.

54. The five principles set out in this Guidance are intended to assist countries in their efforts to improve their AML/CFT regimes. They are not intended to be prescriptive, and should be applied in a manner that is well-considered, is appropriate to the particular circumstances of the country in question and takes into account the way in which legal professionals are regulated in that country and the obligations they are required to observe.

Principle One: Understanding and responding to the threats and vulnerabilities: a national risk assessment

55. Successful implementation of a risk-based approach to combating money-laundering and terrorist financing depends on a sound understanding of the threats and vulnerabilities. Where a country is seeking to introduce a risk-based approach at a national level, this will be greatly aided if there is a national understanding of the risks facing the country. This understanding can flow from a national risk assessment that can assist in identifying the risks.

56. National risk assessments should be tailored to the circumstances of each country. For a variety of reasons, including the structure of designated competent authorities or SROs and the nature of DNFBPs, including legal professionals, each country's judgements about the risks will be unique, as will their decisions about how to implement a national assessment in practice. A national assessment need not be a single formal process or document. The desired outcome is that decisions about allocating responsibilities and resources at the national level are based on a comprehensive and current understanding of the risks. Designated competent authorities and SROs, in consultation with the private sector, should consider how best to achieve this while also taking into account any jurisdictional limitations of applying the risk-based approach to legal professionals, as well as any risk associated with providing information on money laundering and terrorist vulnerabilities.

Principle Two: A legal/regulatory framework that supports the application of a risk-based approach

57. Countries should consider whether their legislative and regulatory frameworks are conducive to the application of the risk-based approach. Where appropriate the obligations imposed should be informed by the outcomes of the national risk assessment.

58. The risk-based approach does not mean the absence of a clear statement of what is required from the DNFBPs, including from legal professionals. However, under a risk-based approach, legal professionals should have a degree of flexibility to implement policies and procedures which respond appropriately to their own risk assessment. In effect, the standards implemented may be tailored

and/or amended by additional measures as appropriate to the risks of an individual legal professional and/or practice. The fact that policies and procedures, in accordance to the risk levels, may be applied to different services, clients and locations does not mean that policies and procedures need not be clearly defined.

59. Basic minimum AML/CFT requirements can co-exist with a risk-based approach. Indeed, sensible minimum standards, coupled with scope for these to be enhanced when the risk justifies it, should be at the core of risk-based AML/CFT requirements. These standards should, however, be focused on the outcome (combating through deterrence, detection, and, when there is a requirement in a particular country, reporting of money laundering and terrorist financing), rather than applying legal and regulatory requirements in a purely mechanistic manner to every client. SROs may assist in the development of such standards for legal professionals.

Principle Three: Design of a monitoring framework to support the application of the risk-based approach

60. In certain countries, SROs play a critical role in the regulation of legal professionals, which may be based on fundamental constitutional principles. Some SROs have the ability to audit or investigate their own members, although in some countries these powers may be limited to reviewing policies and procedures as opposed to specific clients and matters. Depending on the powers of and responsibilities accepted by SROs, SROs may be able to facilitate or ensure compliance by legal professionals with the relevant legislation and/or develop guidance relating to money laundering. In some countries, the SROs may provide a greater level of scrutiny than that which can be afforded by a government or regulatory AML program. SROs should be encouraged to work closely with domestic AML/CFT regulators. Countries should ensure that SROs have appropriate resources to discharge their AML/CFT responsibilities. In some cases, legal professionals may conduct activities falling within the scope of Recommendation 12 that under national law may also require supervision from appropriate authorities.

61. Where appropriate, designated competent authorities and SROs should seek to adopt a risk-based approach to the monitoring of controls to combat money laundering and terrorist financing. This should be based on a thorough and comprehensive understanding of the types of activity carried out by legal professionals, and the money laundering and terrorist financing risks to which these are exposed. Designated competent authorities and SROs will probably need to prioritise resources based on their overall assessment of where the risks are in the legal professionals' practices.

62. Designated competent authorities and SROs with responsibilities other than those related to AML/CFT will need to consider these risks alongside other risk assessments arising from the designated competent authority's or SRO's wider duties.

63. Such risk assessments should help the designated competent authority or SRO choose where to apply resources in its monitoring programme, with a view to using limited resources to achieve the greatest effect. A risk assessment may also indicate that the designated competent authority or SRO does not have adequate resources to deal with the risks. In such circumstances, the designated competent authority or SRO may need to obtain, where possible, additional resources or adopt other strategies to manage or mitigate any unacceptable residual risks.

64. The application of a risk-based approach to monitoring requires that designated competent authorities' and SROs' staff be able to make principle-based decisions in a fashion similar to what would be expected from the staff of a legal professional's practice. These decisions will cover the adequacy of the arrangements to combat money laundering and terrorist financing. As such, a designated competent authority or SRO may wish to consider how best to train its staff in the practical application of a risk-based approach to monitoring. This staff will need to be well-briefed as to the general principles of a risk-based approach, the possible methods of application, and what a risk-based approach looks like when successfully applied within the context of a national risk assessment.

Principle Four: Identifying the main actors and ensuring consistency

65. Countries should consider who the main stakeholders are when adopting a risk-based approach to combating money laundering and terrorist financing. These will differ from country to country. Thought should be given as to the most effective way to share responsibility between these parties, and how information may be shared to best effect. For example, consideration may be given to which body or bodies are best placed to provide guidance to legal professionals about how to implement a risk-based approach to AML/CFT.

66. A list of potential stakeholders may include the following:

- Government – This may include legislature, executive, and judiciary.
- Law enforcement agencies – This might include the police, customs and similar agencies.
- The financial intelligence unit (FIU), security services, and other similar agencies.
- Designated competent authorities/SROs (particularly bar associations and law societies).
- The private sector – This might include legal professionals and law firms and legal professional organisations and associations such as national, state, local, and specialty professional societies and bar associations.
- The public – Arrangements designed to counter money laundering and terrorist financing are ultimately designed to protect the law-abiding public. However, these arrangements may also act to place burdens on clients of legal professionals.
- Others – Those who are in a position to contribute to the conceptual basis underpinning the risk-based approach, such stakeholders may include academia and the media.

67. Clearly a government will be able to exert influence more effectively over some of these stakeholders than others. However, regardless of its capacity to influence, a government will be in a position to assess how all stakeholders can be encouraged to support efforts to combat money laundering and terrorist financing.

68. A further element is the role that governments have in seeking to gain recognition of the relevance of a risk-based approach from designated competent authorities. This may be assisted by relevant authorities making clear and consistent statements on the following issues:

- Legal professionals can be expected to have the flexibility to adjust their internal systems and controls taking into consideration lower and high risks, so long as such systems and controls are reasonable. However, there are also minimum legal and regulatory requirements and elements that apply irrespective of the risk level, such as minimum standards of CDD.
- Acknowledging that a legal professional's ability to detect and deter money laundering and terrorist financing may sometimes be necessarily limited and that information on risk factors is not always robust or freely available. There can therefore be reasonable policy and monitoring expectations about what a legal professional with good controls aimed at preventing money laundering and the financing of terrorism is able to achieve. A legal professional may have acted in good faith to take reasonable and considered steps to prevent money laundering, and documented the rationale for his/her decisions, and yet still be abused by a criminal.

- Acknowledging that not all high-risk situations are identical and as a result will not always require the application of precisely the same type of enhanced due diligence.

Principle Five: Information exchange between the public and private sector

69. Effective information exchange between the public and private sector will form an integral part of a country's strategy for combating money laundering and terrorist financing. In some cases, it will allow the private sector to provide designated competent authorities and SROs with information they identify as a result of previously provided government intelligence. In countries where SROs regulate and monitor legal professionals for AML compliance, such SROs may well acquire information that would be relevant to a country's strategy for combating money laundering and terrorist financing. To the extent that such information may be released in accordance with applicable laws, regulations, and rules, the results may be made available to the designated competent authorities.

70. Public authorities, whether law enforcement agencies, designated competent authorities or other bodies, have privileged access to information that may assist legal professionals to reach informed judgements when pursuing a risk-based approach to counter money laundering and terrorist financing. Likewise, legal professionals are able to understand their clients' legal needs reasonably well. It is desirable that public and private bodies work collaboratively to identify what information is valuable to help combat money laundering and terrorist financing, and to develop means by which this information might be shared in a timely and effective manner.

71. To be productive, information exchange between the public and private sector should be accompanied by appropriate exchanges among public authorities. FIUs, designated competent authorities and law enforcement agencies should be able to share information and feedback on results and identified vulnerabilities, so that consistent and meaningful inputs can be provided to the private sector. All parties should of course, consider what safeguards are needed to adequately protect sensitive information held by public bodies from being disseminated in contravention of applicable laws and regulations.

72. Relevant stakeholders should seek to maintain a dialogue so that it is well understood what information has proved useful in combating money laundering and terrorist financing. For example, the types of information that might be usefully shared between the public and private sector would include, if available:

- Assessments of country risk.

- Typologies or assessments of how money launderers and terrorists have abused DNFBPs, especially legal professionals.

- Feedback on suspicious transaction reports and other relevant reports.

- Targeted unclassified intelligence. In specific circumstances, and subject to appropriate safeguards and a country's legal and regulatory framework, it may also be appropriate for authorities to share targeted confidential information with legal professionals.

- Countries, persons or organisations whose assets or transactions should be frozen.

73. When choosing what information can be properly and profitably shared, public authorities may wish to emphasise to legal professionals that information from public bodies should inform, but not be a substitute for legal professionals' own judgements. For example, countries may decide not to create what are perceived to be definitive country-approved lists of low risk client types. Instead,

public authorities may prefer to share information on the basis that this will be one input into legal professionals' decision making processes, along with any other relevant information that is available to legal professionals.

Chapter Two: Implementation of the Risk-Based Approach

Assessment of Risk to Inform National Priorities:

74. A risk-based approach should be built on sound foundations: effort must first be made to ensure that the risks are well understood. As such, a risk-based approach should be based on an assessment of the threats. This is true whenever a risk-based approach is applied, at any level, whether by countries or individual legal professionals and/or firms. A country's approach should be informed by its efforts to develop an understanding of the risks in that country. This can be considered as a "national risk assessment".

75. A national risk assessment should be regarded as a description of fundamental background information to assist designated competent authorities, law enforcement authorities, the FIU, financial institutions and DNFBPs to ensure that decisions about allocating responsibilities and resources at the national level are based on a practical, comprehensive and up-to-date understanding of the risks.

76. A national risk assessment should be tailored to the circumstances of the individual country, both in how it is executed, and its conclusions, though countries should be mindful that money laundering and terrorist financing can often have an international dimension, and that such information may also add value to the national risk assessment. Factors that may influence the risk of money laundering and terrorist financing in a country could include the following:

- Political environment.
- Legal environment.
- A country's economic structure.
- Cultural factors, and the nature of civil society.
- Sources, location and concentration of criminal activity.
- Size and composition of the financial services industry.
- Ownership structure of financial institutions and DNFBPs businesses.
- Size and nature of the activity carried out by DNFBPs, including legal professionals.
- Corporate governance arrangements in relation to financial institutions and DNFBPs and the wider economy.
- The nature of payment systems and the prevalence of cash-based transactions.
- Geographical spread of the financial industry's and DNFBPs' operations and clients.
- Types of products and services offered by the financial services industry and DNFBPs.
- Types of customers/clients serviced by financial institutions and DNFBPs.
- Types of predicate offences.

- Amounts of illicit money generated domestically.
- Amounts of illicit money generated abroad and laundered domestically.
- Main channels or instruments used for laundering or financing terrorism.
- Sectors of the legal economy affected.
- Underground/informal areas in the economy.

77. Countries should also consider how an understanding of the risks of money laundering and terrorist financing can be best achieved at the national level. Relevant questions could include: Which body or bodies will be responsible for contributing to this assessment? How formal should an assessment be? Should the designated competent authority's or SRO's view be made public? These are all questions for the designated competent authority or SRO to consider.

78. The desired outcome is that decisions about allocating responsibilities and resources at the national level are based on a comprehensive and up-to-date understanding of the risks. To achieve the desired outcome, designated competent authorities and SROs should ensure that they identify and provide DNFBPs (including legal professionals) with the information needed to develop this understanding and to design and implement measures to mitigate the identified risks.

79. Developing and operating a risk-based approach involves forming judgements. It is important that these judgements are well informed. It follows that, to be effective, the risk-based approach should be information-based and include intelligence where appropriate. Effort should be made to ensure that risk assessments are based on fresh and accurate information. Governments utilising partnerships with law enforcement bodies, FIUs, designated competent authorities/SROs and legal professionals themselves, are well placed to bring their knowledge and expertise to bear in developing a risk-based approach that is appropriate for their particular country. Their assessments will not be static and will change over time, depending on how circumstances develop and how the threats evolve. As such, countries should facilitate the flow of information between different bodies, so that there are no institutional impediments to information dissemination.

80. Whatever form they take, a national assessment of the risks, along with measures to mitigate those risks, can inform how resources are applied to combat money laundering and terrorist financing, taking into account other relevant country policy goals. It can also inform how these resources are most effectively assigned to different public bodies and SROs, and how those bodies make use of those resources in an effective manner.

81. As well as assisting designated competent authorities and SROs to decide how to allocate funds to combat money laundering and terrorist financing, a national risk assessment can also inform decision-makers on the best strategies for implementing a regulatory regime to address the risks identified. An over-zealous effort to counter the risks could be damaging and counter-productive, placing unreasonable burdens on legal professionals. Alternatively, less aggressive efforts may not be sufficient to protect society from the threats posed by criminals and terrorists. A sound understanding of the risks at the national level could help obviate these dangers.

Effective systems for monitoring and ensuring compliance with AML/CFT requirements – General Principles

82. FATF Recommendation 24 requires that legal professionals should be subject to effective systems for monitoring and ensuring compliance with AML/CFT requirements. In determining whether there is an effective system, regard may be had to the risk of money laundering or terrorist financing in the sector. There should be a designated competent authority or SRO responsible for

monitoring and ensuring compliance by legal professionals; and the authority or SRO should have adequate powers and resources to perform its functions, including powers to monitor and sanction.

Defining the acceptable level of risk

83. The level of AML/CFT risk will generally be affected by both internal and external risk factors. For example, risk levels may be increased by internal risk factors such as weak compliance resources, inadequate risk controls and insufficient senior management involvement. External level risks may rise due to factors such as the action of third parties and/or political and public developments.

84. As described in Section One, all activity involves an element of risk. Designated competent authorities and SROs should not prohibit legal professionals from conducting business with high risk clients. However, legal professionals would be prudent to identify, with assistance from this or other Guidance, the risks associated with acting for high risk clients. When applicable law prohibits legal professionals from acting for a client, the risk-based approach does not apply.

85. However, this does not exclude the need to implement basic minimum requirements. For instance, FATF Recommendation 5 (that applies to legal professionals through the incorporation of R.5 into R.12) states that "where [the legal professional] is unable to comply with [CDD requirements], it should not open the account, commence business relations or perform the transaction; or should terminate the business relationship; and should consider making a suspicious transaction report in relation to the customer." So the level of risk should strike an appropriate balance between the extremes of not accepting clients, and conducting business with unacceptable or unmitigated risk. As is recognised by the interpretative note to FATF Recommendation 16, however, in those countries where a reporting requirement has been adopted the matters that would fall under legal professional privilege or professional secrecy are determined by each country. [3]

86. Where legal professionals implement a risk-based approach, designated competent authorities and SROs must expect legal professionals to put in place effective policies, programmes, procedures and systems to mitigate the risk and acknowledge that even with effective systems not every suspect transaction will necessarily be detected. They should also ensure that those policies, programmes, procedures and systems are applied effectively to prevent legal professionals from becoming conduits for illegal proceeds and ensure that they keep records and make reports (where obligated) that are of use to national authorities in combating money laundering and terrorist financing. Efficient policies and procedures will reduce the level of risks, but are unlikely to eliminate them completely. Assessing money laundering and terrorist financing risks requires judgement and is not an exact science. Monitoring aims at detecting unusual or suspicious transactions among an extremely large number of legitimate transactions; furthermore, the demarcation of what is unusual may not always be straightforward since what is "customary" may vary depending on the clients' business. This is why developing an accurate client profile is important in managing a risk-based system. Moreover, although procedures and controls are frequently based on previous typologies, criminals will adapt their techniques, which may quickly limit the utility of such typologies.

87. Additionally, not all high risk situations are identical, and therefore will not always require precisely the same level of enhanced due diligence. As a result, designated competent authorities/SROs will expect legal professionals to identify individual high risk categories and apply specific and appropriate mitigation measures. Further information on the identification of specific risk categories is provided in Section Three, "Guidance for Legal Professionals on Implementing a Risk-Based Approach."

[3] See Annex 1 for a summary of decisions by judicial authorities on these issues.

Proportionate Supervisory/Monitoring Actions to support the Risk-Based Approach

88. Designated competent authorities and SROs should seek to identify weaknesses through an effective programme of both on-site and off-site supervision, and through analysis of internal and other available information.

89. In the course of their examinations, designated competent authorities and SROs should review a legal professional's AML/CFT risk assessments, as well as its policies, procedures and control systems to arrive at an overall assessment of the risk profile of legal professionals' practices and the adequacy of their mitigation measures. Where available, assessments carried out by or for legal professionals may be a useful source of information. The designated competent authority/SRO assessment of management's ability and willingness to take necessary corrective action is also a critical determining factor. Designated competent authorities and SROs should use proportionate actions to ensure proper and timely correction of deficiencies, taking into account that identified weaknesses can have wider consequences. Generally, systemic breakdowns or inadequate controls will result in the most severe response.

90. Nevertheless, it may happen that the lack of detection of an isolated high risk transaction, or of transactions of an isolated high risk client, will in itself be significant, for instance where the amounts are significant, or where the money laundering and terrorist financing typology is well known, or where a scheme has remained undetected for a long time. Such a case might indicate an accumulation of weak risk management practices or regulatory breaches regarding the identification of high risks, monitoring, staff training and internal controls, and therefore, might alone justify action to ensure compliance with the AML/CFT requirements.

91. Designated competent authorities and SROs can and should use their knowledge of the risks associated with services, clients and geographic locations to help them evaluate legal professionals' money laundering and terrorist financing risk assessments, with the understanding, however, that they may possess information that has not been made available to legal professionals and, therefore, legal professionals would not have been able to take such information into account when developing and implementing a risk-based approach. Designated competent authorities and SROs (and other relevant stakeholders) are encouraged to use that knowledge to issue guidelines to assist legal professionals in managing their risks. Where legal professionals are permitted to determine the extent of the CDD measures on a risk sensitive basis, this should be consistent with guidelines issued by their designated competent authorities and SROs[4]. Guidance specifically designed for legal professionals is likely to be the most effective. An assessment of the risk-based approach will, for instance, help identify cases where legal professionals use excessively narrow risk categories that do not capture all existing risks, or adopt criteria that lead to the identification of a large number of higher risk relationships, but without providing for adequate additional CDD measures.

92. In the context of the risk-based approach, the primary focus for designated competent authorities and SROs should be to determine whether or not the legal professional's AML/CFT compliance and risk management programme is adequate to: (a) meet the minimum regulatory requirements, and (b) appropriately and effectively mitigate the risks. The monitoring goal is not to prohibit high risk activity, but rather to be confident that legal professionals have adequately and effectively implemented appropriate risk mitigation strategies. Appropriate authorities should, when considering taking action (including applying penalties and sanctions), take into account and give due consideration to the reasoned judgements of legal professionals who are implementing and/or operating an appropriate risk-based approach, which judgements, in hindsight, may ultimately be determined to have been incorrect. In some countries and situations, judicial authorities alone will determine whether the legal professional has complied with the obligation to exercise reasonable judgement.

[4] FATF Recommendations 5 and 25, Methodology Essential Criteria 25.1 and 5.12.

93. Under FATF Recommendation 24, designated competent authorities and SROs should have adequate powers to perform their monitoring functions, including the power to impose adequate sanctions for failure to comply with statutory and regulatory requirements to combat money laundering and terrorist financing. Fines and/or penalties are not appropriate in all regulatory actions, nor will they be permissible in all jurisdictions, to correct or remedy AML/CFT deficiencies. However, subject to the requirements of this paragraph, competent authorities, judicial authorities and SROs must have the authority and willingness to apply appropriate sanctions in cases where substantial deficiencies exist. Often, action will take the form of a remedial programme through the normal monitoring processes.

94. In considering the above factors it is clear that proportionate monitoring will be supported by two central features:

a) Regulatory Transparency

95. In the implementation of proportionate actions, regulatory transparency will be of paramount importance. Designated competent authorities and SROs are aware that legal professionals, while looking for professional freedom to make their own risk judgements, will also seek guidance on regulatory obligations. As such, the designated competent authority/SRO with AML/CFT supervisory/monitoring responsibilities should seek to be transparent in setting out what it expects, and will need to consider appropriate mechanisms of communicating these messages. For instance, this may be in the form of high-level requirements, based on desired outcomes, rather than detailed processes. If SROs responsible for the regulation of the relevant legal professionals (including regulation of AML risks) carry out regular AML compliance reviews of their members or otherwise take measures to supervise compliance, the form of an SRO monitoring programme should be determined by each SRO's rules and regulations.

96. No matter what individual procedure is adopted, the guiding principle will be that there is an awareness of legal responsibilities and regulatory expectations. In the absence of this transparency there is the danger that monitoring actions may be perceived as either disproportionate or unpredictable, which may undermine even the most effective application of the risk-based approach by legal professionals.

b) General Education, Staff Training of Designated Competent Authorities, SROs, and Enforcement Staff

97. SROs or other bodies that have a supervisory or educational role for legal professionals and legal professional organisations all have a stake in an effective risk-based system. This includes making available to legal professionals educational materials, further guidance and increasing awareness of money laundering concerns and risks. Central to the ability of legal professionals to seek to train and guard against money laundering effectively in a risk-based approach, is the provision of realistic typologies, particularly those where there is unwitting involvement.

98. In the context of the risk-based approach, it is not possible to specify precisely what a legal professional has to do, in all cases, to meet its regulatory obligations. Thus, a prevailing consideration will be how best to ensure the consistent implementation of predictable and proportionate monitoring actions. The effectiveness of monitoring training will therefore be important to the successful delivery of proportionate supervisory/monitoring actions.

99. Training should aim to allow designated competent authorities/SRO staff to form sound comparative judgements about AML/CFT systems and controls. It is important in conducting assessments that designated competent authorities and SROs have the ability to make judgements regarding management controls in light of the risks assumed by firms and considering available industry practices. Designated competent authorities and SROs might also find it useful to undertake

comparative assessments so as to form judgements as to the relative strengths and weaknesses of different legal professional organisations' arrangements.

100. The training should include instructing designated competent authorities and SROs about how to evaluate whether senior management has implemented adequate risk management measures, and determine if the necessary procedures and controls are in place. The training should also include reference to specific guidance, where available. Designated competent authorities and SROs also should be satisfied that sufficient resources are in place to ensure the implementation of effective risk management.

101. To fulfil these responsibilities, training should enable designated competent authorities and SROs monitoring staff to adequately assess:

> i. The quality of internal procedures, including ongoing employee training programmes and internal audit, compliance and risk management functions.
>
> ii. Whether or not the risk management policies and processes are appropriate in light of legal professionals' risk profile, and are periodically adjusted in light of changing risk profiles.
>
> iii. The participation of senior management to confirm that they have undertaken adequate risk management, and that the necessary procedures and controls are in place.

102. Educating legal professionals on AML/CFT issues and the risk-based approach is a key element of an effective risk-based approach. Designated competent authorities should thus consider, in discussion with SROs and legal professionals and other appropriate organisations, ways of encouraging educational bodies (such as universities and law schools) to include within the education and training of legal professionals at all levels appropriate references to AML/CFT laws and the appropriate role that legal professionals can play in combating money laundering and terrorist financing.

SECTION THREE: GUIDANCE FOR LEGAL PROFESSIONALS

ON IMPLEMENTING A RISK-BASED APPROACH

Chapter One: Risk Categories

103. Potential money laundering and terrorist financing risks faced by legal professionals will vary according to many factors including the activities undertaken by the legal professional, the type and identity of client, and the nature of the client relationship and its origin. Legal professionals should identify the criteria that enable them to best assess the potential money laundering and where feasible terrorist financing risks their practices give rise to and should then implement a reasonable risk based approach based on those criteria. These criteria are not exhaustive and are not intended to be prescriptive, and should be applied in a manner that is well-considered, is appropriate to the particular circumstances of the country and takes into account the way in which legal professionals are regulated in that country and the obligations they are required to observe.

104. Identification of the money laundering risks and terrorist financing risks associated with certain clients or categories of clients, and certain types of work will allow legal professionals to determine and implement reasonable and proportionate measures and controls to mitigate these risks. Although a risk assessment should normally be performed at the inception of a client relationship, for a legal professional, the ongoing nature of the advice and services the legal professional often provides means that automated transaction monitoring systems of the type used by financial institutions will be inappropriate for many legal professionals. The individual legal professionals working with the client are better positioned to identify and detect changes in the type of work or the nature of the client's activities, this is because the lawyer's knowledge of the client and its business will develop throughout the duration of what is expected to be a longer term relationship. Legal professionals will need to pay attention to the nature of the risks presented by isolated, small and short-term client relationships that, depending upon the circumstances, may be low risk (*e.g.* advice provided to walk-ups in a legal aid clinic).

105. The amount and degree of monitoring will depend on the nature and frequency of the relationship. A legal professional may also have to adjust his or her risk assessment of a particular client based upon information received from a designated competent authority, SRO, or other credible sources.

106. Money laundering and terrorist financing risks may be measured using various categories. Application of risk categories provides a strategy for managing potential risks by enabling legal professionals, where required, to subject each client to reasonable and proportionate risk assessment. The most commonly used risk criteria are: country or geographic risk; client risk; and risk associated with the particular service offered. The weight given to these risk categories (individually or in combination) in assessing the overall risk of potential money laundering or terrorist financing may vary from one legal professional and/or firm to another, particularly given the size, sophistication, nature and scope of services offered by the legal professional and/or firm. These criteria, however, should not be considered in isolation. Legal professionals, in light of their individual practices and based on their reasonable judgements, will need to assess independently the weight to be given to each risk factor.

107. Although there is no universally accepted set of risk categories, the examples provided in this Guidance are the most commonly identified risk categories. There is no single methodology to apply these risk categories, and the application of these risk categories is merely intended to provide a suggested framework for approaching the management of potential risks.

Country/Geographic Risk

108. There is no universally agreed definition by either designated competent authorities, SROs, or legal professionals that prescribes whether a particular country or geographic area (including the country within which the legal professional practices) represents a higher risk. Country risk, in conjunction with other risk factors, provides useful information as to potential money laundering and terrorist financing risks. Money laundering and terrorist financing risks have the potential to arise from almost any source, such as the domicile of the client, the location of the transaction and the source of the funding. Countries that pose a higher risk include:

- Countries subject to sanctions, embargoes or similar measures issued by, for example, the United Nations (UN). In addition, in some circumstances, countries subject to sanctions or measures similar to those issued by bodies such as the UN, but that may not be universally recognised, may be taken into account by a legal professional because of the standing of the issuer of the sanctions and the nature of the measures.

- Countries identified by credible sources[5] as generally lacking appropriate AML/CFT laws, regulations and other measures.

- Countries identified by credible sources as being a location from which funds or support are provided to terrorist organizations.

- Countries identified by credible sources as having significant levels of corruption or other criminal activity.

Client Risk

109. Determining the potential money laundering or terrorist financing risks posed by a client, or category of clients, is critical to the development and implementation of an overall risk-based framework. Based on its own criteria, a legal professional should seek to determine whether a particular client poses a higher risk and the potential impact of any mitigating factors on that assessment. Application of risk variables may mitigate or exacerbate the risk assessment. Categories of clients whose activities may indicate a higher risk include:

- PEPs are considered as higher risk clients – If a legal professional is advising a client that is a PEP, or where a PEP is the beneficial owner of the client, with respect to the activities specified in Recommendation 12, then a legal professional will need to carry out appropriate enhanced CDD, as required by Recommendation 6. Relevant factors that will influence the extent and nature of CDD include the particular circumstances of a PEP, the PEP's home country, the type of work the PEP is instructing the legal professional to perform or carry out, and the scrutiny to which the PEP is under in the PEP's home country.

[5] "Credible sources" refers to information that is produced by well-known bodies that generally are regarded as reputable and that make such information publicly and widely available. In addition to the FATF and FATF-style regional bodies, such sources may include, but are not limited to, supra-national or international bodies such as the International Monetary Fund, the World Bank, and the Egmont Group of Financial Intelligence Units, as well as relevant national government bodies and non-governmental organisations. The information provided by these credible sources does not have the effect of law or regulation and should not be viewed as an automatic determination that something is of higher risk.

- If a PEP is otherwise involved in a client (other than in the circumstances of Recommendation 6), then the nature of the risk should be considered in light of all relevant circumstances, such as:

    - The nature of the relationship between the client and the PEP. Even if the PEP does not have a controlling interest or a dominant position on the board or in management and therefore does not qualify as a beneficial owner, the PEP may nonetheless affect the risk assessment.

    - The nature of the client (*e.g.* is it a public listed company).

    - The nature of the services sought. For example, lower risks may exist where a PEP is not the client but a director of a client that is a public listed company and the client is purchasing real property for adequate consideration.

- Clients conducting their business relationship or requesting services in unusual or unconventional circumstances (as evaluated in all the circumstances of the representation).

- Clients where the structure or nature of the entity or relationship makes it difficult to identify in a timely fashion the true beneficial owner or controlling interests, such as the unexplained use of legal persons or legal arrangements, nominee shares or bearer shares.

- Clients that are cash (and cash equivalent) intensive businesses including:

    - Money services businesses (*e.g.* remittance houses, currency exchange houses, casas de cambio, centros cambiarios, remisores de fondos, bureaux de change, money transfer agents and bank note traders or other businesses offering money transfer facilities).

    - Casinos, betting and other gambling related activities.

    - Businesses that while not normally cash intensive, generate substantial amounts of cash.

- Where clients that are cash intensive businesses are themselves subject to and regulated for a full range of AML/CFT requirements consistent with the FATF Recommendations this may mitigate the risks.

- Charities and other "not for profit" organisations (NPOs) that are not subject to monitoring or supervision (especially those operating on a "cross-border" basis) by designated competent authorities[6] or SROs.

- Clients using financial intermediaries, financial institutions or legal professionals that are not subject to adequate AML/CFT laws and measures and that are not adequately supervised by competent authorities or SROs.

- Clients having convictions for proceeds generating crimes who instruct the legal professional (who has actual knowledge of such convictions) to undertake specified activities on their behalf.

- Clients who have no address, or multiple addresses without legitimate reasons.

- Clients who change their settlement or execution instructions without appropriate explanation.

[6] See Special Recommendation VIII.

- The use of legal persons and arrangements without any apparent legal or legitimate tax, business, economic or other reason.

Service Risk

110. An overall risk assessment should also include determining the potential risks presented by the services offered by a legal professional, noting that the various legal professionals provide a broad and diverse range of services. The context of the services being offered or delivered is always fundamental to a risk-based approach. Any one of the factors discussed in this Guidance alone may not itself constitute a high risk circumstance. High risk circumstances can be determined only by the careful evaluation of a range of factors that cumulatively and after taking into account any mitigating circumstances would warrant increased risk assessment. When determining the risks associated with provision of services related to specified activities, consideration should be given to such factors as:

- Services where legal professionals, acting as financial intermediaries, actually handle the receipt and transmission of funds through accounts they actually control in the act of closing a business transaction.

- Services to conceal improperly beneficial ownership from competent authorities.

- Services requested by the client for which the legal professional does not have expertise excepting where the legal professional is referring the request to an appropriately trained professional for advice.

- Transfer of real estate between parties in a time period that is unusually short for similar transactions with no apparent legal, tax, business, economic or other legitimate reason.[7]

- Payments received from un-associated or unknown third parties and payments for fees in cash where this would not be a typical method of payment.

- Transactions where it is readily apparent to the legal professional that there is inadequate consideration, such as when the client does not identify legitimate reasons for the amount of the consideration.

- Administrative arrangements concerning estates where the deceased was known to the legal professional as being a person who had been convicted of proceeds generating crimes.

- Clients who offer to pay extraordinary fees for services which would not ordinarily warrant such a premium. However, bona fide and appropriate contingency fee arrangements, where a legal professional may receive a significant premium for a successful representation, should not be considered a risk factor.

- The source of funds and the source of wealth – The source of funds is the activity that generates the funds for a client, while the source of wealth describes the activities that have generated the total net worth of a client.

- Unusually high levels of assets or unusually large transactions compared to what might reasonably be expected of clients with a similar profile may indicate that a client not otherwise seen as higher risk should be treated as such. Conversely, low levels of assets or low value transactions involving a client that would otherwise appear to be higher risk might allow for a legal professional to treat the client as lower risk.

[7] See the FATF Typologies report *Money Laundering and Terrorist Financing through the Real Estate Sector* at http://www.fatf-gafi.org/dataoecd/45/31/40705101.pdf.

- Shell companies, companies with ownership through nominee shareholding and control through nominee and corporate directors[8].

- Situations where it is difficult to identify the beneficiaries of trusts; this might include a discretionary trust that gives the trustee discretionary power to name the beneficiary within a class of beneficiaries and distribute accordingly the assets held in trust, and when a trust is set up for the purpose of managing shares in a company that can make it more difficult to determine the beneficiaries of assets managed by the trust[9];

- Services that deliberately have provided or purposely depend upon more anonymity in the client identity or participants than is normal under the circumstances and experience of the legal professional.

- Legal persons that, as a separate business, offer TCSP services should have regard to the TCSP Guidance, even if such legal persons are owned or operated by legal professionals. Legal professionals, however, who offer TCSP services should have regard to this Guidance, and should consider customer or service risks related to TCSPs such as the following:

    - Unexplained use of express trusts.

    - Unexplained delegation of authority by the client through the use of powers of attorney, mixed boards and representative offices.

    - In the case of express trusts, an unexplained relationship between a settlor and beneficiaries with a vested right, other beneficiaries and persons who are the object of a power.

    - In the case of an express trust, an unexplained (where explanation is warranted) nature of classes of beneficiaries and classes within an expression of wishes.

Variables that May Impact Risk

111. Due regard must be accorded to the vast and profound differences in practices, size, scale and expertise, amongst legal professionals. As a result, consideration must be given to these factors when creating a reasonable risk-based approach and the resources that can be reasonably allocated to implement and manage it. For example, a sole practitioner would not be expected to devote an equivalent level of resources as a large law firm; rather, the sole practitioner would be expected to develop appropriate systems and controls and a risk-based approach proportionate to the scope and nature of the practitioner's practice.

112. A significant factor to consider is whether the client and proposed work would be unusual, risky or suspicious for the particular legal professional. This factor must always be considered in the context of the legal professional's practice. A legal professional's risk-based approach methodology may thus take into account risk variables specific to a particular client or type of work. Consistent with the risk-based approach and the concept of proportionality, the presence of one or more of these variables may cause a legal professional to conclude that either enhanced due diligence and monitoring is warranted, or conversely that normal CDD and monitoring can be reduced, modified or simplified. These variables may increase or decrease the perceived risk posed by a particular client or type of work and may include:

[8] See also the FATF typologies report ''The Misuse of Corporate Vehicles, including Trust and Company Service Providers" published 13 October 2006.

[9] See also the FATF typologies report "The Misuse of Corporate Vehicles, including Trust and Company Service Providers" Annex 2 on trusts, for a more detailed description of "potential for misuse" of trusts.

- The nature of the client relationship and the client's need for the legal professional to provide specified activities.

- The level of regulation or other oversight or governance regime to which a client is subject. For example, a client that is a financial institution or legal professional regulated in a country with a satisfactory AML/CFT regime poses less risk of money laundering than a client in an industry that has money laundering risks and yet is unregulated for money laundering purposes.

- The reputation and publicly available information about a client. Legal persons that are transparent and well known in the public domain and have operated for a number of years without being convicted of proceeds generating crimes may have low susceptibility to money laundering.

- The regularity or duration of the relationship.

- The familiarity of the legal professional with a country, including knowledge of local laws, regulations and rules, as well as the structure and extent of regulatory oversight, as the result of a legal professional's own activities within the country.

- The proportionality between the magnitude or volume and longevity of the client's business and its legal requirements, including the nature of professional services sought.

- Subject to other factors (including the nature of the services and the source and nature of the client relationship), providing limited legal services in the capacity of a local or special counsel may be considered a low risk factor. This may also, in any event, mean that the legal professional is not "preparing for" or "carrying out" a transaction for a regulated activity specified in Recommendation 12.

- Significant and unexplained geographic distance between the legal professional organisation and the location of the client where there is no nexus to the type of work being undertaken.

- Where a prospective client has instructed the legal professional to undertake a single transaction-based service (as opposed to an ongoing advisory relationship) and one or more other risk factors are present.

- Risks that may arise from the use of new or developing technologies that permit non-face to face relationships and could favour anonymity. However, due to the prevalence of electronic communication between legal professionals and clients in the delivery of legal services, non-face to face interaction between legal professionals and clients should not, standing alone, be considered a high risk factor. For example, non-face to face, cross-border work for an existing client is not necessarily high risk work for certain organisations (such as regional, national or international law firms or other firms regardless of size that practice in that type of work) nor would customary services rendered by a sole practitioner on a local basis to a client in the local community who does not otherwise present increased risks.

- The nature of the referral or origination of the client. A prospective client may contact a legal professional in an unsolicited manner or without common or customary methods of introduction or referrals, which may increase risk. By contrast, where a prospective client has been referred from another trusted source subject to an AML/CFT regime that is in line with the FATF standards, the referral may be considered a mitigating risk factor.

- The structure of a client or transaction. Structures with no apparent legal, tax, business, economic or other legitimate reason may increase risk. Legal professionals often design

structures (even if complex) for legitimate legal, tax, business, economic or other legitimate reasons, in which case the risk of money laundering could be reduced.

- Trusts that are pensions may be considered lower risk.

Controls for Higher Risk Situations

113. Legal professionals should implement appropriate measures and controls to mitigate the potential money laundering and terrorist financing risks with respect to those clients that, as the result of the legal professional or firm risk-based approach, are determined to be higher risk. Paramount among these measures is the requirement to train legal professionals and appropriate staff to identify and detect changes in activity by reference to risk-based criteria. These measures and controls may include:

- General training on money laundering methods and risks relevant to legal professionals.
- Targeted training for increased awareness by the legal professionals providing specified activities to higher risk clients or to legal professionals undertaking higher risk work.
- Increased levels of CDD or enhanced due diligence for higher risk situations.
- Escalation or additional review and/or consultation by the legal professional or within a firm at the establishment of a relationship.
- Periodic review of the services offered by the legal professional and/or firm to determine whether the risk of money laundering and terrorist financing occurring has increased.
- Reviewing client relationships from time to time to determine whether the risk of money laundering and terrorist financing occurring has increased.
- The same measures and controls may often address more than one of the risk criteria identified, and it is not necessarily expected that a legal professional establish specific controls targeting each risk criterion.

Chapter Two: Application of a Risk-Based Approach

Customer Due Diligence/Know Your Customer

114. Client Due Diligence/Know Your Client is intended to enable a legal professional to form a reasonable belief that it has appropriate awareness of the true identity of each client. The legal professional's procedures should apply in circumstances where a legal and professional is preparing for or carrying out[10] the activities listed in Recommendation 12 and include procedures to:

a) Identify and appropriately verify the identity of each client on a timely basis.

b) Identify the beneficial owner, and take reasonable measures to verify the identity of the beneficial owner such that the legal professional is reasonably satisfied that it knows who the beneficial owner is. The general rule is that clients should be subject to the full range of CDD measures, including the requirement to identify the beneficial owner in accordance with this paragraph. The purpose of identifying beneficial ownership is to ascertain those natural persons who exercise effective control over a client, whether by means of ownership, voting

[10] See paragraphs 12-13 regarding when a legal professional would or would not be engaged in "preparing for" or "carrying out" transactions for clients, and hence the requirements of Recommendation 12 would apply.

rights or otherwise. Legal professionals should have regard to this purpose when identifying the beneficial owner. They may use a risk-based approach when determining the extent to which they are required to identify the beneficial owner, depending on the type of client, business relationship and transaction and other appropriate factors in accordance with Recommendation 5 and its Interpretative Note, § 9-12[11].

c) Obtain appropriate information to understand the client's circumstances and business depending on the nature, scope and timing of the services to be provided. This information may be obtained from clients during the normal course of their instructions to legal professionals.

115. The starting point is for a legal professional to assess the risks that the client may pose taking into consideration any appropriate risk variables (and any mitigating factors) before making a final determination. The legal professional's assessment of risk will then inform the overall approach to CDD requirements and appropriate verification. Legal professionals will reasonably determine the CDD requirements appropriate to each client given the legal professional's familiarity with the client, which may include:

- A standard level of CDD, generally to be applied to all clients.
- The standard level being reduced after consideration of appropriate risk variables, and in recognised lower risk scenarios, such as:
    - Publicly listed companies (and their majority owned subsidiaries).
    - Financial institutions (domestic or foreign) subject to an AML/CFT regime consistent with the FATF Recommendations.
    - Government authorities and state run enterprises (other than those from sanctioned countries).
- An increased level of CDD in respect of those clients that are reasonably determined by the legal professional to be of higher risk. This may be the result of the client's business activity, ownership structure, particular service offered including work involving higher risk countries or defined by applicable law or regulation as posing higher risk, such as the risks outlined in paragraphs 108-109.

Monitoring of Clients and Specified Activities

116. The degree and nature of monitoring by a legal professional will depend on the type of legal professional, and if it is a firm, the size and geographic 'footprint' of the firm, the AML/CFT risks that the firm has identified and the nature of the regulated activity provided. Given the nature of the advisory relationship legal professionals have with their clients and that an element of that advisory relationship will usually involve frequent client contact, monitoring is typically best achieved by trained individuals having contact with the client (either face to face or by other means of communication). For purposes of paragraphs 116 to 118 (and related paragraphs), "monitoring" does not oblige the legal professional to function as, or assume the role of, a law enforcement or investigative authority vis-a-vis his or her client. It rather refers to maintaining awareness throughout

[11] Legal professionals should have regard to the Interpretative Notes to Recommendation 5 and the AML/CFT 2004 Methodology Essential Criteria 5.5 and 5.8-5.12, which, among other things, provide more details on the measures that need to be taken to identify beneficial owners, and the impact of higher or lower risk on the required measures.

the course of work for a client to money laundering or terrorist financing activity and/or changing risk factors.

117. Monitoring of these advisory relationships cannot be achieved solely by reliance on automated systems and whether any such systems would be appropriate will depend in part on the nature of a legal professional's practice and resources reasonably available to the legal professional. For example, a sole practitioner would not be expected to devote an equivalent level of resources as a large law firm; rather, the sole practitioner would be expected to develop appropriate monitoring systems and a risk-based approach proportionate to the scope and nature of the practitioner's practice. A legal professional's advisory relationships are best monitored by the individuals having direct client contact being appropriately trained to identify and detect changes in the risk profile of a client. Where appropriate this should be supported by systems, controls and records within a framework of support by the firm (*e.g.* tailored training programs appropriate to the level of staff responsibility).

118. Legal professionals should also assess the adequacy of any systems, controls and processes on a periodic basis. Monitoring programs can fall within the system and control framework developed to manage the risk of the firm. The results of the monitoring may also be documented.

119. The civil law notary does not represent parties to a contract and therefore must maintain a fair position with regard to any duty to both parties.

Suspicious Transaction Reporting

120. This Guidance does not address FATF Recommendations relating to suspicious transaction reporting (STR) and the proscription against "tipping off" those who are the subject of such reports. Different countries have undertaken different approaches to these Recommendations of the FATF. Where a legal or regulatory requirement mandates the reporting of suspicious activity once a suspicion has been formed, a report must be made and, therefore, a risk-based approach for the reporting of the suspicious activity under these circumstances is not applicable. STRs are not part of risk assessment, but rather reflect a response mechanism – typically to an SRO or government enforcement authority – once a suspicion of money laundering has been identified. For those reasons, this Guidance does not address those elements of the FATF Recommendations.

Education, Training and Awareness

121. Recommendation 15 requires that legal professionals provide their staff with AML/CFT training, and it is important that legal professional staff receive appropriate and proportional training with regard to money laundering. For legal professionals, and those in smaller firms in particular, such training may assist with monitoring obligations. A legal professional's commitment to having appropriate controls relies fundamentally on both training and awareness. This requires a firm-wide effort to provide all relevant legal professionals with at least general information on AML/CFT laws, regulations and internal policies. To satisfy a risk-based approach, particular attention should be given to risk factors or circumstances occurring in the legal professional's own practice. In addition, governments, SROs and other representative bodies for both common and civil law notaries and bar associations should work with educational institutions to see that both legal professionals, and students taking courses to train for or become legal professionals, are educated on money laundering and terrorist financing risks. For example, bar societies and associations should be encouraged to produce continuing legal education programs on AML/CFT and the risk-based approach.

122. Applying a risk-based approach to the various methods available for training, however, gives each legal professional flexibility regarding the frequency, delivery mechanisms and focus of such training. Legal professionals should review their own staff and available resources and implement training programs that provide appropriate AML/CFT information that is:

- Tailored to the relevant staff responsibility (*e.g.* client contact or administration).

- At the appropriate level of detail (*e.g.* considering the nature of services provided by the legal professional).

- At a frequency suitable to the risk level of the type of work undertaken by the legal professional.

- Used to test to assess staff knowledge of the information provided.

Chapter Three: Internal Controls

123. Many DNFBPs differ significantly from financial institutions in terms of size. By contrast to most financial institutions, a significant number of DNFBPs have only a few staff. This limits the resources that small businesses and professions can dedicate to the fight against money laundering and terrorist financing. For a number of DNFBPs, a single person may be responsible for the functions of front office, back office, money laundering reporting, and senior management. This particularity of DNFBPs, including legal professionals, should be taken into account in designing a risk-based framework for internal controls systems. The Interpretative Note to Recommendation 15, dealing with internal controls, specifies that the type and extent of measures to be taken for each of its requirements should be appropriate having regard to the size of the business.

124. To enable legal professionals to have effective risk-based approaches, the risk-based process must be a part of the internal controls of the legal professional or firm. Legal professionals operate within a wide range of differing business structures, from sole practitioners to large partnerships. These structures often mean that legal professionals' businesses have a flat management structure and that most or all of the principals (or partners) of the firm hold ultimate management responsibility. In other organisations, legal professionals employ corporate style organisational structures with tiered management responsibility. In both cases the principals or the managers are ultimately responsible for ensuring that the organisation maintains an effective internal control structure. Engagement by the principals and managers in AML/CFT is an important aspect of the application of the risk-based approach since such engagement reinforces a culture of compliance, ensuring that staff adheres to the legal professional's policies, procedures and processes designed to limit and control money laundering risks.

125. The nature and extent of the AML/CFT controls, as well as meeting national requirements, need to be proportionate to the risk involved in the services being offered. In addition to other compliance internal controls, the nature and extent of AML/CFT controls will depend upon a number of factors, such as:

- The nature, scale and complexity of a legal professional's business.

- The diversity of a legal professional's operations, including geographical diversity.

- The legal professional's client, service and activity profile.

- The degree of risk associated with each area of the legal professional's operations.

- The services being offered and the frequency of client contact (either in person or by other means of communication).

126. Subject to the size and scope of the legal professional's organisation, the framework of risk-based internal controls should:

- Have appropriate risk management systems to determine whether a client, potential client, or beneficial owner is a PEP.

- Provide increased focus on a legal professional's operations (*e.g.* services, clients and geographic locations) that are more vulnerable to abuse by money launderers.

- Provide for periodic review of the risk assessment and management processes, taking into account the environment within which the legal professional operates and the activity in its marketplace.

- Designate personnel at an appropriate level who are responsible for managing AML/CFT compliance.

- Provide for an AML/CFT compliance function and review programme if appropriate given the scale of the organisation and the nature of the legal professional's practice.

- Inform the principals of compliance initiatives, identified compliance deficiencies and corrective action taken.

- Provide for programme continuity despite changes in management or employee composition or structure.

- Focus on meeting all regulatory record keeping or other requirements, as well as promulgated measures for AML/CFT compliance and provide for timely updates in response to changes in regulations.

- Implement risk-based CDD policies, procedures and processes.

- Provide for adequate controls for higher risk clients and services as necessary, such as review with or approvals from others.

- Provide for adequate supervision and support for staff activity that forms part of the organisation's AML/CFT programme.

- Incorporate AML/CFT compliance into job descriptions and performance evaluations of relevant personnel.

- Provide for appropriate training to be given to all relevant staff.

- For groups, to the extent possible, provide a common control framework.

ANNEXES

ANNEX 1

SOURCES OF FURTHER INFORMATION

Various sources of information exist that may help governments and legal professionals in their development of a risk-based approach. Although not an exhaustive list, this Annex 1 highlights a number of useful web-links that governments and legal professionals may wish to draw upon. They provide additional sources of information, and further assistance might also be obtained from other information sources such AML/CFT assessments.

A. Financial Action Task Force Documents

The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. Key resources include the 40 Recommendations on Money Laundering and 9 Special Recommendations on Terrorist Financing, the Methodology for Assessing Compliance with the FATF Recommendations, the Handbook for Countries and Assessors, methods and trends (typologies) reports and mutual evaluation reports.

www.fatf-gafi.org

B. Legislation/and Court Decisions

The rulings by the ECJ of June 26th 2007 by the Belgium Constitution Court of January 23rd 2008 and the French Conseil d'État of April 10th, 2008 have confirmed that anti-money laundering regulation cannot require or permit the breach the lawyer's duty of professional secrecy when performing the essential activities of the profession. In addition, the Court of First Instance in the Joined Cases T-125/03 &T-253/03 Akzo Nobel Chemicals Ltd and Akcros Chemicals Ltd v Commission of the European Communities has recently restated the ruling in the *AM&S* case that professional secrecy "meets the need to ensure that every person must be able, without constraint, to consult a lawyer whose profession entails the giving of independent legal advice to all those in need of it (*AM&S*, paragraph 18). That principle is thus closely linked to the concept of the lawyer's role as collaborating in the administration of justice by the courts (*AM&S*, paragraph 24).

C. Links to Information on the Supervisory Program in Certain Countries

Switzerland

1. See articles 18 to 21 of the lawyers and notaries' SRO regulations (SRO SAV/SNV): www.sro-sav-snv.ch/fr/02_beitritt/01_regelwerke.htm/02_Reglement.pdf

2. See articles 38 and 45 to 47 of the lawyers and notaries' SRO statutes (SRO SAV/SNV): www.oad-fsa-fsn.ch/fr/02_beitritt/01_regelwerke.htm/01_Statuten.pdf

D. Guidance on the Risk-based Approach

1. Law Society of Ireland: www.lawsociety.ie.

2. Law Society of England and Wales: www.lawsociety.org.uk

3. Law Society of Hong Kong: www.hklawsoc.org.hk

4. Organisme d'autoréglementation de la fédération suisse des avocats et de la fédération suisse des notaires (SRO SAV/SNV): home page: www.sro-sav-snv.ch/ www.sro-sav-snv.ch/fr/02_beitritt/01_regelwerke.htm/02_Reglement.pdf (art. 41 to 46)

5. The Netherlands Bar Association: www.advocatenorde.nl

6. The Royal Dutch Notarial Society: www.notaris.nl

E. Other sources of information to help assist countries' and legal professionals' risk assessment of countries and cross-border activities

In determining the levels of risks associated with particular country or cross border activity, legal professionals and governments may draw on a range of publicly available information sources, these may include reports that detail observance of international standards and codes, specific risk ratings associated with illicit activity, corruption surveys and levels of international cooperation. Although not an exhaustive list the following are commonly utilised:

- IMF and World Bank Reports on observance of international standards and codes (Financial Sector Assessment Programme)
    - World Bank reports: www1.worldbank.org/finance/html/cntrynew2.html
    - International Monetary Fund: www.imf.org/external/np/rosc/rosc.asp?sort=topic#RR
    - Offshore Financial Centres (OFCs) IMF staff assessments www.imf.org/external/np/ofca/ofca.asp

- Mutual evaluation reports issued by FATF Style Regional Bodies:

    1. Asia/Pacific Group on Money Laundering (APG) www.apgml.org/documents/default.aspx?DocumentCategoryID=8

    2. Caribbean Financial Action Task Force (CFATF) www.cfatf.org/profiles/profiles.asp

    3. The Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL)

    www.coe.int/t/e/legal_affairs/legal_co-operation/combating_economic_crime/5_money_laundering/Evaluations/Reports_summaries3.asp#TopOfPage

    4. Eurasian Group (EAG)

www.eurasiangroup.org/index-7.htm
5. GAFISUD
www.gafisud.org/miembros.htm

6. Middle East and North Africa FATF (MENAFATF)
www.menafatf.org/TopicList.asp?cType=train

7. The Eastern and South African Anti Money Laundering Group (ESAAMLG)
www.esaamlg.org/

8. Groupe Inter-gouvernemental d'Action contre le Blanchiment d'Argent (GIABA)
www.giabasn.org/?lang=en&sid

- OECD Sub Group of Country Risk Classification (a list of country of risk classifications published after each meeting)
www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_1,00.html

- International Narcotics Control Strategy Report (published annually by the US State Department)
www.state.gov/p/inl/rls/nrcrpt/

- Egmont Group membership - Coalition of financial intelligence units that participate in regular information exchange and the sharing of good practice, acceptance as a member of the Egmont Group is based a formal procedure that countries must go through in order to be acknowledged as meeting the Egmont definition of an FIU.
www.egmontgroup.org/

- Signatory to the United Nations Convention against Transnational Organized Crime
www.unodc.org/unodc/crime_cicp_signatures_convention.html

- The Office of Foreign Assets Control ("OFAC") of the US Department of the Treasury economic and trade, Sanctions Programmes
www.ustreas.gov/offices/enforcement/ofac/programs/index.shtml

- Consolidated list of persons, groups and entities subject to EU Financial Sanctions
http://ec.europa.eu/comm/external_relations/cfsp/sanctions/list/consol-list.htm

- UN Security Council Sanctions Committee - Country Status:
www.un.org/sc/committees/

ANNEX 2

GLOSSARY OF TERMINOLOGY

Beneficial Owner

Beneficial owner refers to the natural person(s) who ultimately owns or controls a client and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.

Competent authorities

Competent authorities refers to all administrative and law enforcement authorities concerned with combating money laundering and terrorist financing, including the FIU and supervisors.

Designated Non-Financial Businesses and Professions (DNFBPs)

a. Casinos (which also includes internet casinos).
b. Real estate agents.
c. Dealers in precious metals.
d. Dealers in precious stones.
e. Lawyers, notaries, other independent legal professionals and accountants – this refers to sole practitioners, partners or employed professionals within professional firms. It is not meant to refer to 'internal' professionals that are employees of other types of businesses, nor to professionals working for government agencies, who may already be subject to measures that would combat money laundering.
f. Trust and Company Service Providers refers to all persons or businesses that are not covered elsewhere under the Recommendations, and which as a business, provide any of the following services to third parties:

- Acting as a formation agent of legal persons.
- Acting as (or arranging for another person to act as) a director or secretary of a company, a partner of a partnership, or a similar position in relation to other legal persons.
- Providing a registered office; business address or accommodation, correspondence or administrative address for a company, a partnership or any other legal person or arrangement.
- Acting as (or arranging for another person to act as) a trustee of an express trust.
- Acting as (or arranging for another person to act as) a nominee shareholder for another person.

Express Trust

Express trust refers to a trust clearly created by the settlor, usually in the form of a document *e.g.* a written deed of trust. They are to be contrasted with trusts which come into being through the operation of the law and which do not result from the clear intent or decision of a settlor to create a trust or similar legal arrangements (*e.g.* constructive trust).

FATF Recommendations

Refers to the FATF Forty Recommendations and the FATF Nine Special Recommendations on Terrorist Financing.

Legal Person

Legal person refers to bodies corporate, foundations, anstalt, partnerships, or associations, or any similar bodies that can establish a permanent client relationship with a legal professional or otherwise own property.

Legal Professional

In this Guidance, the term *"Legal professional"* refers to lawyers, civil law notaries, common law notaries, and other independent legal professionals.

Politically Exposed Persons (PEPs)

Individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves. The definition is not intended to cover middle ranking or more junior individuals in the foregoing categories.

Self-regulatory organisation (SRO)

A body that represents a profession (*e.g.* lawyers, notaries, other independent legal professionals or accountants), and which is made up of member professionals or a majority thereof, has a role (either exclusive or in conjunction with other entities) in regulating the persons that are qualified to enter and who practise in the profession, and also performs certain supervisory or monitoring type functions. For example, it would be normal for this body to enforce rules to ensure that high ethical and moral standards are maintained by those practising the profession.

ANNEX 3

MEMBERS OF THE ELECTRONIC ADVISORY GROUP

FATF and FSRB members and observers
Argentina; Asia Pacific Group (APG); Australia; Belgium; Azerbaijan; Canada; Chinese Taipei, China; European Commission (EC); Nigeria; France; Hong Kong, China; Italy; Japan; Luxembourg; MONEYVAL; Netherlands; New Zealand; Offshore Group of Banking Supervisors (OGBS); Portugal; Romania; Spain; South Africa; Switzerland; United Kingdom; United States.

Dealers in precious metals and dealers in precious stones industries
Antwerp World Diamond Centre, International Precious Metals Institute, World Jewellery Confederation, Royal Canadian Mint, Jewellers Vigilance Committee, World Federation of Diamond Bourses, Canadian Jewellers Association.

Real estate industry
International Consortium of Real Estate Agents, National Association of Estate Agents (UK), the Association of Swedish Real Estate Agents.

Trust and company service providers industry
The Society of Trust and Estate Practitioners (STEP), the Law Debenture Trust Corporation.

Accountants
American Institute of Certified Public Accountants, Canadian Institute of Chartered Accountants, European Federation of Accountants, German Institute of Auditors, Hong Kong Institute of Public Accountants, Institute of Chartered Accountants of England & Wales.

Casino industry
European Casino Association (ECA), Gibraltar Regulatory Authority, Kyte Consultants (Malta), MGM Grand Hotel & Casino, Unibet, William Hill plc.

Lawyers and notaries
Allens Arther Robinson, American Bar Association (ABA), American College of Trust and Estate Council, Consejo General del Notariado (Spain), Council of the Notariats of the European Union, Council of Bars and Law Societies of Europe (CCBE), International Bar Association (IBA), Law Society of England & Wales, Law Society of Upper Canada.

Second Report to the ABA of the Proceedings of the NCCUSL Drafting Committee on the "Insurable Interests Relating to Trusts" Uniform Act

Reported by David Neufeld, ABA Advisor to the Committee

October 4, 2008, Chicago, Illinois

The following comments are mine alone based on my observations. Nothing stated herein is intended to be taken as official commentary on these proceedings, which can only be issued by official channels within the NCCUSL. The background of this project was outlined in a report dated March 1, 2008.

At this, the second meeting of the drafting committee the discussion centered on resolving the expressed concerns of the Bar and those of the insurance industry. The Bar expressed a need to expeditiously resolve the issues that arose from the *Chawla*[1] case. The insurance industry felt that this vehicle should be crafted in a way that it also blocks (or at least does not promote) certain STOLI ("stranger owned life insurance") related transactions, in particular those transactions that depend on the assignment of beneficial interests in ILITs.

The Chair (Prof. Roger Henderson) and Reporter (Prof. Robert Jerry) expressed their goal that (1) the draft be STOLI neutral, that is not preventing nor promoting STOLI, (2) there be no conflict with or change to a state's existing insurable interest law and that this Act work as an overlay, and (3) that it be crafted in a way that it could easily be adopted by any state regardless of whether it already enacted the UTC, has not yet enacted the UTC, or will place this Act into its insurance code.

Discussion ensued about (1) the need to provide certainty for the estate planning community about the propriety of ILITs as a technical legal matter (the *Chawla* issue), (2) the desire of the Bar that the Act be drafted in a way that mitigates legislative roadblocks to expeditious passage, especially to avoid becoming entangled in the Insurable Interest War being waged between the insurance industry and the life settlement industry,[2] (3) the desire of the Bar to make sure that trust settlors are not prevented from achieving ends with life insurance acquired through a trust that they would otherwise

---

[1] *Chawla, ex rel Geisinger v. Transamerica Occidental Life Insurance Co.*, 2005 WL 405405 (E.D. Va. 2005), *aff'd in part, vac'd in part*, 440 F.3d 639 (4th Cir, 2006)

[2] The NAIC and the NCOIL each have presented model legislation that would address STOLI concerns, either by amending the insurable interest law (the NCOIL approach, preferred by the life settlement industry) or more directly (the NAIC approach, preferred by the insurance industry). The committee felt that this issue was being adequately addressed in these venues as well as the courts and the instant Act need not also address it one way or another.

be permitted to achieve if the policy were owned directly, (4) the fact that this Act must work seamlessly with existing insurable interest law of each state, regardless of what that might be, and (5) the need to neither create new opportunities for abuse of the insurable interest law nor to deny opportunities to legitimate uses of premium financing or life settlements. After discussion and language modifications, the representative from the insurance industry concluded that it seems that the draft is being crafted in a way that was acceptable, and the insurance industry would likely take a neutral stance, instead looking to the NCOIL/NAIC bills to achieve its goals.

The remainder of the meeting was spent developing the appropriate language. What follows is the preliminary draft language preceded by my informal comments. The language is still in a state of flux and will continue to be so even after it receives final committee approval and is submitted to the style committee.

Comments about the language chosen:

1. We use the definition of settlor already in the UTC, but modify it to be limited to those who create the trust, excluding those who are settlors by virtue of contributing property.
2. We anticipated the occasional need of a custodian, conservator or other type of fiduciary to create an insurance trust and did not want to foreclose that possibility.
3. The term "person" was chosen over the term "individual" to avoid foreclosing the ability of non-natural trust settlors to settle insurance trusts and acquire policies.
4. As this Act is "subject to" other applicable law, such as insurable interest laws, employee benefit laws, etc., it simply acts as an overlay. Thus, it solves the *Chawla* problem but does not create an insurable interest if state law specifically provides otherwise in any given context.
5. Specifically addressing the *Chawla* question, the Act turns on the fundamental approach that the settlor is deemed to step into the shoes of a direct policy owner, and therefore the trustee's insurable interest is derived from whatever interest the settlor has. Furthermore the trust beneficiaries are irrelevant to this inquiry. Of particular concern to most of those in attendance are those existing "anti-*Chawla*" laws that require an examination of the trust beneficiaries to determine insurable interest, particularly those laws employing the term "primarily." In some legitimate planning it may be impossible to determine who the ultimate beneficiaries will be or their relative shares, let alone whether any one beneficiary or group of beneficiaries possess more than 50%. It is feared that this might lead to crippling litigation rather than to calm the issue.
    a. If the insured and the settlor are one and the same the trustee has insurable interest in an insured, following the universal rule (among states which address this) that a direct policy owner has insurable interest in himself/herself. Just as an insured who acquires a policy on his own life can designate anyone as a beneficiary of the policy, so too can a settlor designate anyone as a beneficiary of the trust without destroying insurable interest.

b. If the insured is not the settlor the trustee will be deemed to have insurable interest in that insured if state law (legislative or common) gives the settlor insurable interest in the insured if the settlor had directly owned the policy.
c. The clause in (b)(2) "or would have if living at the time of the issuance of the policy" acknowledges that existing ancient dynasty trusts might find it appropriate to acquire a policy on a descendant of a pre-deceased settlor. That settlor's death does not prevent trust assets from being deployed to insure the life of a distant descendant, i.e. someone the settlor would have an insurable interest in were the settlor alive today.

The following is a preliminary draft of the language approved by the Committee at the meeting. It is subject to change.

SECTION [_]. INSURABLE INTEREST; APPLICABILITY.

(a) For purposes of this section, the term settlor is limited to a person who executes the trust instrument. If a trust instrument is executed by a fiduciary or agent, the person for whom the fiduciary or agent is acting is the settlor.

(b) Subject to other applicable law of this state, a trustee of a trust has an insurable interest in the life of an individual insured under a life insurance policy owned by the trustee of the trust if on the date the policy is issued the individual whose life is insured is:

(1) a settlor of the trust; or

(2) an individual in whom a settlor of the trust has, or would have had if living at the time of the policy was issued, an insurable interest.

[ALTERNATIVE A (for states that have not yet enacted the UTC)]

(c) Subsection (a) applies to any life insurance policy, owned by a trustee, issued before, on, or after the effective date of this [Code], if the policy is in force and an insured is alive on or after the effective date of the [Code].

[ALTERNATIVE B (as an amendment to the UTC for states that have previously enacted the UTC or as an amendment to a state's insurance code]

(c) This section applies to any trust existing before, on, or after the effective date of the section, regardless of the effective date of the governing instrument under which the trust was created, but only as to a life insurance policy that is in force and for which an insured is alive on or after the effective date of the section.

Request for input and suggestions

The role of the ABA Advisor is to be a resource to the Drafting Committee as well as a conduit of information between interested parties within the ABA and the Chairman of the Drafting Committee. In that regard I am soliciting input from interested Sections and Committees concerning the issues outlined herein. Our next meeting will likely be the first reading in June, 2009.

Distribution:
ABA Secretary: Armando Lasa-Ferrer (alasa@lmvpr.com)
RPTE Section Director: Robin Roy (robinroy@staff.abanet.org)
RPTE Section Chair: Steven Akers (akers@bessemer.com)
RPTE Section Chair-Elect: Roger Winston (winstonr@ballardspahr.com)
Business Law Section Chair: Karl Ege (kege@perkinscoie.com)
ABA Staff Liaison to NCCUSL: Robin Roy (robinroy@staff.abanet.org)
NCCUSL CAO: J. Elizabeth Cotton-Murphy (elizabeth.cotton@nccusl.org)
Drafting Committee Chair: Roger Henderson (henderson@law.arizona.edu)

First Report to the ABA of the Proceedings of the NCCUSL Drafting Committee on the "Insurable Interests Relating to Trusts" Uniform Act

Reported by David Neufeld, ABA Advisor to the Committee

March 1, 2008, Chicago, Illinois

On March 1, 2008, the NCCUSL Drafting Committee on the "Insurable Interests Relating to Trusts" Uniform Act (the "Committee") convened its first meeting, after two months of preliminary exchanges of emails among committee members, the ABA Advisor and observers. The scope of the Committee's task is narrow: to address the issues that came to light with the *Chawla*[i] case in a uniform manner among the several states, presumably as an amendment to the Uniform Trust Act, with the alternative possibility that it might be enacted in any given state as an amendment to a state's insurance code.

Background

It might be safe to say that until the District Court for the Eastern District of Virginia weighed in on the interpretation of the Maryland insurable interest law as it applied to insurance trusts ("ILITs") in 2005 most estate planning practitioners gave little thought about whether an ILIT could acquire a life insurance policy. In fact it was assumed that this just was the case. Whether such blissful ignorance across the industry was merited or not, that case opened a can of worms with its secondary ruling that the trustee possessed no insurable interest in the life of the insured and the policy was *void ab initio*. The world of estate planners was rocked. When the Court of Appeals for the 4th Circuit had a chance to address this issue and bring us back to bliss they went only part of the way. In affirming the decision on the basis of the primary ruling, it vacated the District Court's secondary ruling on insurable interest as unnecessary dicta. This helped the litigants but still left this gaping hole in ILIT related planning for everyone else. The fix then became legislative.

As of this writing six states have enacted legislation in an attempt to restore order. While some seem to share similarities and others are completely distinct, in fact each has its own unique characteristic. In essence we have six different approaches developing. In an article published in the ACTEC Journal by Mary Ann Mancini and Howard Zaritsky,[ii] the authors thoroughly analyze the history of insurable interest law, both generally and as it relates to trusts, discuss the *Chawla* case and dissect the legislative responses to *Chawla* thusfar, concluding with a call for a uniform and better approach than is already out there for providing for an insurable interest law relating to a trust as purchaser of life insurance. This article precipitated the current effort by NCCUSL.

The Scope of the Drafting Project

The "Project Proposal Form" from the NCCUSL Committee on Scope and Program states:

> . . . [T]he study committee has concluded that a drafting committee should be created to amend the Uniform Trust Code by developing a bracketed provision that addresses the use of life insurance trusts in estate planning in a manner to eliminate any issues about the validity of the life insurance policy because of the possibility the trustee or trust has no insurable interest in the life of the person who is the subject of the insurance.

Thus, the drafting committee will attempt to draft a provision that would provide ILITs with insurable interest as otherwise defined in the relevant state's laws. The scope does not extend to revising what is and is not an insurable interest generally, but rather to adapt ILITs to the existing law.

The drafting committee is composed of several commissioners and myself as ABA Advisor. In addition the Chairman has invited interested individuals and representatives from interested organizations as observers to provide their views during preliminary consideration of the project.

Results of the first meeting

The Committee defined two issues that might be addressed within the scope of its charge, defined in shorthand as "the *Chawla* issue" and "the STOLI issue."

The first issue easily fits within the Scope, with the most complicated issue being how to provide a trustee with insurable interest in situations where one might intuitively expect there to be insurable interest but closer scrutiny creates some doubt. For instance there seems to be uniform acceptance among practitioners that if, as is the case, spouses and children have an insurable interest in a spouse/parent so too does a trustee of a trust benefitting these same individuals. Also, of course, the insured always has an insurable interest in himself and therefore practitioners might expect that a trust created by the insured as grantor has an insurable interest in the grantor. But, the question was raised, what about the following situations, among others:

1. some, most or all of the trust beneficiaries might be individuals themselves without insurable interest, such as cousins, grandchildren and spouses of grandchildren;
2. the trust contains spray and other discretionary provisions that might result in trust beneficiaries not on the list of those with insurable interests receiving all of the trust assets; or
3. the trust grantor is not the insured and in fact the trust is an ancient trust created generations ago by a grantor no longer living.

The second issue, referred to in shorthand as the STOLI issue (STOLI being the acronym for "stranger owned life insurance," also referred to as "investor owned life insurance" or IOLI, among other names), deals with those insurance sales that on its face satisfy all legal requirements but whose underlying facts might support a finding that an investor arranged with an insured (or someone else with an insurable interest in the insured) to acquire a policy pursuant to a pre-existing plan to purchase the policy from the policy owner sometime after the policy is issued. This might be susceptible to attack on a form-over-substance argument or similar judicial tool, leading to a conclusion that the policy is void, as the true owner might be held to be the investor without an insurable interest. In the context of ILITs, a STOLI transaction might also arise in a situation where a trust beneficiary is obligated from the inception of the transaction to sell his beneficial interest in the trust to an investor. In this case the trust might have the requisite insurable interest in the insured but a thorough review of the trust beneficiaries and their legal obligations might indicate an arrangement intended to side-step the insurable interest law. Thus one concern of the Committee is whether the trust's insurable interest depends on who are the trust's beneficiaries, both nominally and in reality. If so then the bona fide nature of those beneficiaries may be considered as within the Scope. If not, or if the general application of the insurable interest law as in existence would handle this problem, then it would seem to be an external issue.

Among the working assumptions to come out of the first meeting are:

1. The Committee's efforts will focus on the trust grantor as analogous to the acquirer of the policy, such that if the individual who is grantor would have an insurable interest in the insured had he acquired the policy directly, then the trust/trustee has insurable interest, notwithstanding who are the beneficiaries (with a possible fix for the ancient trust issue).
2. Understanding that STOLI in the context of trusts concern two possible types of transactions (one being the acquisition of the policy by the trust with the intent of <u>selling the policy</u> to an investor, and the other being the acquisition of the policy by the trust with the intent of a trust beneficiary selling <u>the beneficial interest in the trust</u> to an investor) the Committee's effort will not concentrate

on those situations which concern whether the trust bought a policy with the intent of selling it but instead will, at most, consider issues arising from the sale of beneficial interests. This may prove to be an issue better handled in the context of general insurable interest law and not necessarily in the context of trusts, i.e. if the insurable interest law of a given state looks to, inter alia, who receives the insurance proceeds, then perhaps this already includes an examination of who receives trust distributions composed of those insurance proceeds. Whether the Committee covers sales of beneficial interests or considers it also to be better folded into general insurable interest law will continue to be reviewed.

The Chair parceled out responsibilities to three meeting participants to draft versions of legislation with alternative approaches, inviting others to contribute if they wish.

Request for input and suggestions

The role of the ABA Advisor is to be a resource to the Drafting Committee as well as a conduit of information between interested parties within the ABA and the Chairman of the Drafting Committee. In that regard I am soliciting input from interested Sections and Committees concerning the issues outlined herein. Our next meeting is scheduled for October/November 2008 although progress is expected to be made with interim correspondence.

Distribution:
ABA Secretary: Armando Lasa-Ferrer (alasa@lmvpr.com)
RPTE Section Director: Robin Roy (robinroy@staff.abanet.org)
RPTE Section Chair: Kathleen Martin (kmm@mgmllp.com)
RPTE Section: Chair-Elect Steven Akers (akers@bessemer.com)
Business Law Section Chair: Charles McCallum (mccallce@wnj.com)
ABA Staff Liaison to NCCUSL: Robin Roy (robinroy@staff.abanet.org)
NCCUSL CAO: J. Elizabeth Cotton-Murphy (elizabeth.cotton@nccusl.org)
Drafting Committee Chair: Roger Henderson (henderson@law.arizona.edu)

---

[i] *Chawla, ex rel Geisinger v. Transamerica Occidental Life Insurance Co.*, 2005 WL 405405 (E.D. Va. 2005), *aff'd in part, vac'd in part*, 440 F.3d 639 (4th Cir, 2006)
[ii] "Insurable Interests: Apres *Chawla*, le Deluge?" 32 ACTEC Journal 194 (2006).

FY 2009-02

October 2008

Illinois Department of Revenue

Informational Bulletin

Brian Hamer
Director of Revenue

Pass-through Entity Payments

To: All tax professionals, S corporations, partnerships, and trusts.

For information or forms...

- Call us at:
  1 800 732-8866 or
  217 782-3336
- Call our TDD (telecommunications device for the deaf) at:
  1 800 544-5304
- Write us at:
  Illinois Department of Revenue
  P.O. Box 19044
  Springfield, IL 62794-9044
- Visit our web site at:
  tax.illinois.gov
- Call our 24-hour Forms Order Line at:
  1 800 356-6302

This bulletin is written to inform you of recent changes; it does not replace statutes, rules and regulations, or court decisions.

Printed by authority of the State of Illinois
110,000 copies - 10/08 - P.O. Number 2090199

This bulletin provides detailed information regarding the new law that requires partnerships, S corporations, and trusts (pass-through entities) to make tax payments on behalf of their nonresident partners, shareholders, and beneficiaries (nonresident owners).

What is the new law on withholding by pass-through entities?

For tax years ending on or after December 31, 2008, PA 95-0233 (SB 1544) and PA 95-0707 (SB 783) require pass-through entities to make Illinois tax payments on behalf of nonresident owners. Although this is referred to as "pass-through entity withholding," it is not true withholding. Instead, the pass-through entity is required to make a payment based on its nonresident owners' share of apportioned Illinois business income. If the pass-through entity's payment covers the nonresident owner's Illinois Individual Income Tax obligation, that owner does not need to file Form IL-1040, Individual Income Tax Return.

The pass-through entity is required to notify the nonresident owner of the amount of pass-through entity payment made on his behalf. The nonresident owner who does file an Illinois tax return must report the income and is allowed to take credit for the pass-through entity payment reported to him.

What does the new law require pass-through entities to do?

Pass-through entities that have nonresident owners must file Form IL-1000, Pass-through Entity Payment Income Tax Return, and make a pass-through entity payment on behalf of those nonresident owners.

Pass-through entity payments are required for all nonresident owners, except

- individuals for whom the pass-through entity files Form IL-1023-C, Illinois Composite Income and Replacement tax return; or
- non-individual owners, who document to the pass-through entity on Form IL-1000-E, Certificate of Exemption for Pass-through Entity Payments, that they will file a return and pay the Illinois Income Tax.

The pass-through entity must provide nonresident owners with a Schedule K-1-P, Partner's or Shareholder's Share of Income Deductions, Credits, and Recapture, or Schedule K-1-T, Beneficiary's Share of Income and Deductions, that shows the amount of pass-through entity payments made on their behalf.

NOTE: Nonresident owners are required to attach Schedule K-1-P or K-1-T to their Illinois tax return and cannot receive credit for the payments made on their behalf without the documentation.

The pass-through entity must also accept completed and signed copies of Form IL-1000-E, from non-individual owners who elect not to have pass-through payments made on their behalf.

You should keep copies of Form IL-1000-E in your files. At any time, we may request to review those certificates.

What does the new law require nonresident owners to do?

If the pass-through entity payment covers the nonresident owner's Illinois Individual Income Tax obligation, no IL-1040 must be filed.

If the nonresident owner files an Illinois Income Tax return for any reason, the income passed through from the entity must be reported, and a credit can be taken for the pass-through entity payment made on his behalf.

How is the pass-through entity payment calculated?

The pass-through payment equals the sum of each nonresident owner's share of the business income from the pass-through entity apportioned to Illinois, times the Illinois tax rate applicable to that owner.

When are pass-through payments due?

Pass-through payments and Form IL-1000 are due no later than the pass-through entity's original due date (without regard to any extension) for filing its Illinois income tax return. For example, an S corporation using a calendar taxable year would submit its 2008 payment by March 15, 2009.

What forms will be used?

- ***Form IL-1000, Pass-through Entity Payment Income Tax Return,*** must be completed and signed. Any amount shown due on Form IL-1000 should be sent with the tax return.

  NOTE: **Do not make pass-through entity payments on Form IL-941, Illinois Quarterly Withholding Income Tax Return.**

- ***Form IL-1000-X, Amended Pass-through Entity Payment Income Tax Return,*** must be completed by a pass-through entity to report an underpayment of tax due on Form IL-1000.

- ***Form IL-1000-E, Certificate of Exemption for Pass-through Entity Payments,*** must be used for those owners who are not individuals, to make the election to forgo the pass-through payment process and elect to pay the required tax on their annual tax return.

- ***Schedule K-1-P, Partner's or Shareholder's Share of Income, Deductions, Credits, and Recapture,*** must be used by the pass-through entity to inform the partners and shareholders of the amount of pass-through entity payment made on their behalf.

  Schedule K-1-P must be used by partners and shareholders to claim a credit for the amount of pass-through payment made on their behalf on their annual tax returns.

- ***Schedule K-1-T, Beneficiary's Share of Income and Deductions,*** must be used by the pass-through entity to notify beneficiaries of a trust of the amount of pass-through payments made on their behalf.

  Schedule K-1-T must be used by the beneficiaries of a trust that made pass-through payments on their behalf to claim a credit for the amount on their annual tax returns.

What are the requirements when the owner of an entity is also a pass-through entity (tiered partnerships and distributions)?

Pass-through entities that are owners of a pass-through entity with Illinois business income must file Form IL-1000, and make a pass-through entity payment for their nonresident owners on the Illinois business income passed through to them, as well as on any Illinois business income they earn directly. The tiered entity must issue Schedule(s) K-1-P or K-1-T to its owners.

Example:

Partnership A has business income of $1,000 and an Illinois apportionment factor of 40 percent, for a total Illinois-sourced income of $400. It has two equal partners:

- Individual A, an Indiana resident, and
- Partnership B, a partnership doing business only in Indiana. Partnership B has not submitted an IL-1000-E. It has two equal partners, both individual residents of Ohio.

Partnership A must file an IL-1000 and make a total pass-through entity payment of $9.00:

$200 x 3 percent = $6.00 distributable to Individual A, and

$200 x 1.5 percent = $3.00 distributable to Partnership B.

Partnership B must file an IL-1000 and make $6 in pass-through entity payments on the $200 of Illinois business income that passed through to it from Partnership A:

$100 x 3 percent = $3.00 distributable to Individual Ohio resident A, and

$100 x 3 percent = $3.00 distributable to Individual Ohio resident B.

Partnership B must also file an IL-1065 and pay replacement tax on the $200. It may claim a credit for the $3 of pass-through entity payments made on its behalf on either its Form IL-1000 or Form IL-1065.

NOTE: If Partnership B submits an IL-1000-E to Partnership A, Partnership A will not be required to make a pass-through entity payment on the $200 distributable to Partnership B. However, Partnership B will still be required to pay replacement tax and make pass-through entity payments on the $200.

How will my partners, shareholders, and beneficiaries claim the pass-through payments?

We are adding lines to all tax returns that allow pass-through entity payments to be credited towards an Illinois taxpayer's tax liability. This includes Forms

- *IL-1040, Individual Income Tax Return,*
- *IL-1120, Corporation Income and Replacement Tax Return,*
- *IL-1120-ST, Small Business Corporation Replacement Tax Return,*
- *IL-1065, Partnership Replacement Tax Return, and*
- *IL-1041, Fiduciary Income and Replacement Tax Return,*
- *IL-1023-C, Composite Income and Replacement Tax Return.*

New columns are also added on Forms IL-1065 and IL-1120-ST, Schedule B, and Form IL-1041, Schedule D. Partnerships, S corporations, and trusts will provide separate owner information on these schedules that will allow us to match pass-through payment amounts.

What about software vendors?

The IL-1000 and IL-1000-X will be part of the tax forms the vendors may wish to create. In addition, Form IL-1000-V will be available for submission of payments. (This is similar to the existing IL-1040-V, IL-1120-V, *etc.*)

What about electronic filing?

We are unable to accept the Form IL-1000 and payments electronically for the 2008 tax year. In addition, nonresident individuals claiming a credit may not file their Form IL-1040 electronically. A paper Form IL-1040 must be filed.

What if I am overpaid? Can I file an amended return?

If you overpaid your tax on Form IL-1000, you cannot file an amended return. The owner will be responsible for filing an annual tax return and claiming any overpayment. Form IL-1000-X is for increased deficiencies only.

Where can I ask questions or find updated information?

At this time, this bulletin contains the most up-to-date detailed information regarding pass-through entity withholding. As new information becomes available, we will add it to our web page under "Businesses, Featured Topics."

Questions may also be submitted on our web site's new blog, "Tax Talk."

Quick Check

If you are a **pass-through entity**, you must:

- ✓ Use Form IL-1000 to make pass-through entity payments on behalf of your Illinois nonresident owners, unless the owner has filed Form IL-1000-E.
- ✓ Notify all nonresident owners of their pass-through payment amount on Schedules K-1-P or K-1-T.
- ✓ File your annual Illinois income or replacement tax return and pay any Illinois tax liability.
- ✓ Maintain exemption information from business owners who file Form IL-1000-E.

If you are an **owner who is not a pass-through entity**:

- ✓ Do nothing, if the pass-through entity payments reported on your Schedule K-1-P or K-1-T covers your Illinois Income Tax liability.
- ✓ File your Illinois income and replacement tax return and pay any remaining liability.

If you are **a pass-through entity that is also an owner of a pass-through entity receiving distributable Illinois-sourced income**, you must

- ✓ Make the election to have the pass-through entity make payments on your behalf or file Form IL-1000-E with the entity and pay the tax liability yourself;
- ✓ Make pass-through entity payments for your nonresident owners on the income passed through to you by the pass-through entity, as well as on any Illinois business income earned directly by you;
- ✓ Make the election to treat any pass-through payment made for you as a credit on your Illinois income or replacement tax return or use the credit as the pass-through payment for your owners if you do not file Form IL-1000-E.
- ✓ File your Illinois income and replacement tax return and pay any remaining liability.

AMERICAN BAR ASSOCIATION

Section of Real Property, Trust & Estate Law
321 North Clark Street
Chicago, Illinois 60654-7598
FAX: (312) 988-5262
http://www.abanet.org/rpte
E-mail: rpte@abanet.org

December 1, 2008

By e-mail to Comments@FDIC.gov

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Revocable Trust Accounts
12 CFR Part 330, RIN 3064-AD33

Dear Mr. Feldman:

The attached comments are in response to the interim rule promulgated by the Federal Deposit Insurance Corporation ("FDIC"), appearing in Pages 56706-56712 of the Federal Register dated September 30, 2008 (Volume 73, Number 190), effective September 26, 2008 for insurance coverage on revocable trust accounts (the "Interim Rule"). The comments are being submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (the "Section"). They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Non-Tax Issues Affecting the Planning and Administration of Estates and Trusts Committee of the Trust and Estate Division of the Section. Although the members of the Section who prepared these comments have clients who would be affected by the principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or the outcome of, the specific subject matter of these comments.

If you have any questions regarding these comments, please do not hesitate to contact Elizabeth Lindsay-Ochoa, Vice-Chair of the Non-Tax Issues Affecting the Planning and Administration of Estates and Trusts Committee, at lizochoa@gmail.com.

Very truly yours,

Steve R. Akers
Section Chair

cc: Bernice B. Donald, ABA Secretary
Thomas M. Susman, Director, ABA Governmental Affairs
Alan F. Rothschild, Jr., Vice-Chair, ABA Section of Real Property, Trust and Estate Law
Mary O'Reilly, Chair, Non-Tax Issues Affecting the Planning & Admin. of Estates & Trusts Committee, ABA Section of Real Property, Trust and Estate Law
Richard Nenno, Chair, Wealth and Non-Tax Estate Planning Considerations Group, ABA Section of Real Property, Trust and Estate Law
Laura Twomey, Vice Chair, Wealth and Non-Tax Estate Planning Considerations Group, ABA Section of Real Property, Trust and Estate Law
Steven B. Gorin, Committee on Governmental Submissions, ABA Section of Real Property, Trust and Estate Law

COMMENTS OF THE AMERICAN BAR ASSOCIATION, SECTION OF REAL PROPERTY, TRUST AND ESTATE LAW CONCERNING IN RESPONSE TO FEDERAL DEPOSIT INSURANCE CORPORATION (the "FDIC") INTERIM RULE WITH REQUEST FOR COMMENTS REGARDING REVOCABLE TRUST ACCOUNTS

I. INFORMATION ON THE DRAFT OF THIS RESPONSE

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

The comments were prepared by members of the Non-Tax Issues Affecting the Planning and Administration of Estates and Trusts Committee (the "Committee") of the Trust and Estate Division of the ABA's Section of Real Property, Trust and Estate Law (the "Section"). Mary O'Reilly, Chair of the Committee, supervised the preparation of these comments and participated in their preparation.

The principal drafting responsibility was exercised by Jason G. Neroulias, and substantive contributions were made by Elizabeth Lindsay-Ochoa and Mary O'Reilly. Others who participated were Mario A. Pacione, Suzanne Luna and Mina Sirkin. These comments were reviewed Steven B. Gorin on behalf of the Section's Committee on Governmental Submissions.

Contact person: Phone Number:
Elizabeth Lindsay-Ochoa 212-314-4650

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

II. BACKGROUND

The Emergency Economic Stabilization Act of 2008, signed by President George W. Bush on October 3, 2008 temporarily increased the basic limit on FDIC insurance coverage from $100,000 to $250,000 per depositor. The increase is effective from October 3, 2008 through December 31, 2009, after which the coverage limit will return to $100,000.

The FDIC issued the Interim Rule to simplify the rules for revocable trust accounts "to make the rules easier to understand and apply, without decreasing coverage currently available for revocable trust account owners." [1]

III. FDIC REQUESTS SPECIFIC COMMENTS ON THE INTERIM RULE

The FDIC invited comments on all aspects of the Interim Rule. Additionally, the FDIC requested specific comments on: (1) whether "over $500,000" is the proper threshold for determining coverage for revocable trust account owners based on the beneficial interests of the trust beneficiaries[2]; (2) whether the FDIC's irrevocable trust account rules should be revised so that all trusts are covered by substantially the same rules; and (3) what effect the Interim Rule will have on the level of insured deposits.

The Section appreciates the opportunity to comment. However, our comments are limited to how any thresholds the FDIC deems appropriate should apply to trusts..

IV. SUMMARY OF RECOMMENDATIONS

The Section respectfully suggests that the FDIC:

1. Apply the Interim Rule to both revocable and irrevocable trusts. This would provide certainty and clarify FDIC coverage for all trusts while eliminating the complex evaluations under the current rules due to variation in coverage amounts available between revocable and irrevocable trusts with contingent and non-contingent beneficiaries.

2. Expand the definition of "non-contingent trust interest" so that beneficiaries other than beneficiaries with a life estate and other than beneficiaries who receive their interests outright will also be entitled to FDIC coverage.

V. THE FDIC'S IRREVOCABLE TRUST ACCOUNT RULES SHOULD BE REVISED SO THAT ALL TRUSTS ARE COVERED BY SUBSTANTIALLY THE SAME RULES

In light of the FDIC's goal of alleviating confusion and uncertainty when determining deposit insurance amounts of revocable trusts with the Interim Rule, we recommend that the FDIC amend the Interim Rule so that it applies to both revocable and irrevocable trust accounts. The Interim Rule provides that irrevocable trusts which are created from a revocable trust upon the death of the revocable trust owner will continue to be insured

[1] Interim rule issued September 26, 2008. 12 CFR Part 330.

[2] FDIC Financial Institution Letters (FIL-99-2008, revised as of October 8, 2008) increased the previous $500,000 limit to a $1,250,000 limit.

under the revocable trust rules. We suggest that the Interim Rule apply to all irrevocable trusts regardless of whether the irrevocable trust is created at the moment a revocable trusts becomes irrevocable or if it is irrevocable from the outset. This will simplify the tasks of advisors making recommendations based on insurance amounts, as well as simplify the tasks of the FDIC in making claim determinations. Further, we are unaware of any policy reason to distinguish between irrevocable trusts merely due to the circumstances of their creation, since the rights of a trust's beneficiaries do not depend on such a distinction.

VI. EXPAND THE DEFINITION OF "NON-CONTINGENT TRUST INTEREST"

We are pleased that the Interim Rule expanded the class of beneficiaries entitled to coverage to include any beneficiary who is a natural person, a charity or other non-profit, regardless of marriage, lineal or collateral relationship. However, only those beneficiaries who possess a trust interest capable of determination without evaluation of contingencies except for those covered by the present worth tables and rules of calculation for their use set forth in § 20.2031-7 of the Federal Estate Tax Regulations are eligible for coverage.[3]

Essentially, under the current rules, including the Interim Rule (the "Current Rules"), only those beneficiaries who are granted a life estate or who will receive their interest outright are entitled to coverage. Although this rule provides appropriate protection for beneficiaries of informal revocable trusts accounts, such as Totten Trusts or POD accounts, it does not provide sufficient coverage for beneficiaries of formal revocable trusts and irrevocable trusts, which are commonly used as estate planning vehicles.

Commonly used trust vehicles, such as a sprinkle trust or a dynasty trust, can be left with minimal FDIC coverage because the trust beneficiaries' interests do not fall under the definition of a "non-contingent trust interest." Such estate planning vehicles are often an integral part of a comprehensive estate plan because of their significant tax and non-tax advantages. As a consequence of limiting the coverage available to those beneficiaries who posses a "non-contingent" interest, individuals and their advisor are left having to choose between increased FDIC coverage and the appropriate estate planning vehicle.

Thus, we recommend that the definition of "non-contingent trust interest" be expanded to include discretionary beneficiaries and presumptive remainderman of discretionary trusts. If such a change is not possible, we recommend that such definition be expanded to include any beneficiary whose distributions are subject to an ascertainable standard, as such term is defined in section 2514(c)(1) of the Internal Revenue Code and the Treasury

---

[3] Definition from 330.10:

(l) *Non-contingent trust interest* means a trust interest capable of determination without evaluation of contingencies except for those covered by the present worth tables and rules of calculation for their use set forth in § 20.2031--7 of the Federal Estate Tax Regulations (26 CFR 20.2031--7) or any similar present worth or life expectancy tables which may be adopted by the Internal Revenue Service.

Regulations thereunder. The tax laws view such a standard as granting beneficiaries enforceable rights.

VII. CONCLUSION

We hope that additional consideration by the FDIC on revocable and irrevocable trust accounts will provide rules that increase consumer confidence while ensuring the rules are easy for the public to understand and treat similarly situated beneficiaries in a similar manner. We appreciate your consideration of our comments and welcome the opportunity to discuss them further with you.