ACTEC 2013 Fall Meeting Musings

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This summary reflects the individual observations of Steve Akers from the seminars at the 2013 Fall Meeting and does not purport to represent the views of ACTEC as to any particular issues.

Steve R. Akers

Senior Fiduciary Counsel — Southwest Region, Bessemer Trust
300 Crescent Court, Suite 800
Dallas, TX 75201
214-981-9407
akers@bessemer.com
www.bessemer.com

BESSEMER TRUST

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Important Information Regarding This Summary
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Introduction

Some of my observations from the 2013 ACTEC Fall Meeting Seminars in Fort Worth, Texas on October 25-26, 2013 are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely selected issues. The summary is based on the presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-7 are observations from a seminar by Kenneth W. Kingma and M. Read Moore, Legal Migrants: Clients Who Move Between Community Property and Common Law States

1. What is Community Property?

a. ***Community.*** In order to have community property, there must be a "community" (typically a marriage). Same-sex couples can have community property if the state recognizes the validity of the marriage for state law purposes. The states differ as to whether the community property system applies to domestic registered partners—it does in Nevada but not in Wisconsin.

b. ***General Approach.*** Under community property systems, all property of the spouses constitutes either "separate" or "community" property. The community property system derives from civil law, whereas "common law" property systems derive from English law, under which title is critical in determining ownership of property.

c. ***Separate Property.*** A spouse's separate property includes (1) property owned or claimed by the spouse prior to marriage, (2) property acquired during marriage by gift or inheritance, and (3) in some states, the recovery for personal injuries sustained during marriage except for recovery for loss of earning capacity. If separate property is sold or exchanged, the resulting proceeds are also separate property, but only if they can be traced to the original separate property.

d. ***Community Property.*** All other property acquired during marriage by either spouse is generally community property.

e. ***Income from Separate Property.*** Income from separate property remains separate property in five community property states (Arizona, California, New Mexico, Washington and Wisconsin) but is community property in the other four community property states (Idaho, Texas, Louisiana and Wisconsin). Treating income from separate property as community property can result in complexities resulting from the mixing of community property income with the separate asset. For example, if interest and dividends (which are treated as income) are retained in a separate property brokerage account, the account becomes "mixed" property – partly separate and partly community property.

f. ***Mixed or Commingled Property; Tracing.*** Assets may be partly separate and partly community property. For example, if a property is purchased partly with the separate property of one or both spouses and partly with community property, the property will be owned jointly by the separate and community property estates in proportion to the consideration provided by each. As discussed above, if income from separate property is treated as community property and accumulates in the account, the "commingling" causes the account to be partly separate and partly community property.

"Tracing" is required to determine the portion of mixed property that constitutes separate property. The tracing can be difficult to establish because of the community property presumption (addressed immediately below).

g. ***Community Property Presumption.*** Property acquired during marriage by the spouses while domiciled in a community property state is presumed to be community property. The community property presumption can be rebutted by clear and convincing evidence to establish the portion of the property that is attributable to property acquired prior to marriage by gift or inheritance or with separate property funds.

   One professor uses the analogy of two separate property hills with a community property valley between them. If a spouse wants to prove that assets are his or her separate property, the spouse must bear the burden of pushing those assets up the hill—or else they fall down to the community property valley.

h. ***Title and Possession Not Critical.*** The source of funds used to acquire property determines whether the property is separate or community. In common law property states, the manner in which an asset is *titled* generally determines its ownership. In community property states, the manner in which title is acquired generally does not matter; for example, an asset title in the husband's name may still constitute community property.

   There are several exceptions to this general rule in some states. For example, property conveyed to one spouse as his or her "sole and separate property" is the separate property of the spouse if the other spouse participated in the transaction. In addition, property transferred from one spouse to the other spouse, absent evidence to the contrary, is typically presumed to constitute a gift to the donee-spouse as his or her separate property. Similarly, if a spouse uses his or her separate property to purchase an asset that is titled in both spouses' names, the transferor spouse is presumed to have made a gift of one-half interest in the property the other spouse as his or her separate property.

i. ***Inception of Title; Reimbursement Rights.*** Most community property states follow the "inception of title" approach, under which the separate or community character of an asset is determined when the asset is acquired, and its character will not be altered without a subsequent transfer or commingling. (Other community property states apply an "apportionment rule.") In inception of title states, an expenditure of time or money of one spouse in connection with an asset of the other spouse will not change the character of the asset; instead, an equitable right of reimbursement might arise. For example, if one spouse acquires an asset before marriage with outstanding debt, and community property is used to make payments on the debts during marriage, the asset continues as separate property, but the community estate may be entitled to reimbursement for the actual amounts of funds expended. (However, an offset to the reimbursement right may exist if the community estate benefited from use of the separate property asset.)

j. ***Transmutation.*** In most community property states, spouses may agree to treat property as community property that would otherwise be separate property.

k. ***Community Property States and Foreign Jurisdictions.*** Historically, there have been eight community property states – Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. The community property systems in these states have generally evolved from Spanish law (although the Louisiana system derives from French law). In addition, Wisconsin has adopted a Uniform Marital Property Act that does not have the same Spanish law background but is a community property system.

   Alaska has adopted the Uniform Marital Property Act on an elective basis (i.e., spouses can opt-in to the community property system). The IRS has not indicated whether it will respect the community property character of property under the Alaska opt-in system for federal tax purposes. (Oklahoma and Oregon had opt-in community property systems briefly, but they were quickly repealed.)

   Most non-English speaking civil law countries have marital property systems much like community property. For example, China has been community property system that is much like the California system. Similarly, clients who lived in France, Spain or Latin America might have some form of community property. On the other hand, English speaking foreign countries (for example, England and Canada) typically do not have community property systems.

l. ***Community Property Trust (Alaska and Tennessee).*** Under Alaska and Tennessee legislation, nonresidents of those states can establish a community property trust, and if the trust satisfies the requirements of the legislation, property transferred to the trust becomes community property under Alaska or Tennessee law. Most states require a trustee to be a resident of the state, and the trustee must have certain minimum powers. In Tennessee, when property is distributed from the community property trust, it is no longer community property. The community property characterization will likely be recognized in other states, because choice of law provisions are generally respected unless they contradict a strong public policy of the domicile state. Conjuring up a strong public policy against having property owned equally by the spouses is difficult. The community property characterization will probably also be recognized under §1014(b)(6) because it refers to the law of "any state" (rather than just referring to the law of the state of domicile). The IRS has not confirmed that result; IRS Publication No. 555, "Community Property" (released March 2012) states that the Publication does not address the taxation of "income or property subject to the 'community property' election under Alaska state laws."

2. Significance of Characterization of Property as Separate or Community Property

a. ***Property Rights.***

   Ownership. Community property assets are owned one-half by each spouse (generally on an asset-by-asset basis).

   Management. Spouses typically have co-extensive management rights over community property. Therefore, spouses must generally join in transferring community property. (In some states, such as Texas, a spouse has sole management rights over community property that would have constituted that spouse's separate property if single, such as personal earnings. Joint management community property is community property other than sole management community property of either spouse. If spouses combine their respective sole management community property, the commingled property becomes joint management community property.)

Creditors' Rights. Community property characterization determines the property that one spouse's creditor can reach. The creditor rules vary among the community property states.

Survivorship Rights. Historically, community property could not be held as tenants by the entirety or as joint tenants with right of survivorship. However, some states now have legislation allowing spouses to hold community property with survivorship rights. (The IRS has recognized that community property with rights of survivorship will continue to be treated as community for tax purposes as long as it is recognized as community property under state law. Rev. Rul. 87-98.)

Rights to Make Gifts. Some community property states prohibit a spouse from making gifts of community property assets. Other states allow a spouse to give property over which he or she has sole management authority unless the gift would be a "fraud" on the other spouse's community property rights.

b. ***Division on Divorce.*** In a divorce, the common starting point is that community property is divided 50-50 between the spouses, and each spouse keeps his or her separate property. Some states allow a division of the community property in accordance with an equitable "just and right" division power of the court.

c. ***Division at Death.*** At death, the deceased spouse can dispose of his or her separate property and his or her one-half interest in community property (including community property titled in the name of the other spouse). All community property is typically subject to administration for a limited period of time (principally to deal with creditors' rights).

d. ***Tax Effects.***

Income tax. Each spouse owns one-half of the income for income tax purposes, so there is income splitting between the spouses. At the death of either spouse, both halves of community property receive an adjusted basis under §1014(b)(6). (In common law states, only property owned by the decedent receives a basis adjustment.)

Gift tax. Gifts of community property are automatically made one-half by each spouse. (Accordingly, gift splitting is not as important in community property states as in common law states.)

Estate tax. The decedent's gross estate includes his or her separate property and one-half of community property. Because community property states generally do not recognize tenancy by the entirety or joint tenancy with right of survivorship, there is typically is not much property listed on Schedule E (Jointly Owned Property) of the Form 706, but most assets are listed on Schedules A-F.

Agreement. Spouses could conceivably adopt a system for ownership of the property that is similar to the community property system. If so, the property would not be recognized as community property for tax purposes.

3. General Impact of Migrating Between Community and Common Law States On Marital Property

a. ***General Rules.*** Under the American choice of law system governing marital property rights, the law governing a married couple's property depends upon where the couple is living from time to time (the "mutability" principle). (This is contrasted with the approach followed by European countries where the choice of law rules generally follow the immutability principle-that the laws of the couple's first marital domicile determine the character of their property.)

The law of the state in which a married couple is domiciled at the time real or personal property is acquired determines the character of that property. The character of community property or common-law property generally does not change upon the couple's move to another state. For example, when spouses move from a community property state to a common law property state, property acquired with community property funds and traceable to those funds continues to be community property, despite the fact that the couple then lives in a common law state. Restatement (Second) of Conflicts of Laws §259. In that circumstance, a sale of the original asset does not change the character of the proceeds of such sale. Id. Various court cases have recognized this principle particularly with respect to personal property that is moved from a community property to a common law state. (An exception to this general rule is the quasi-community property doctrine recognized in some community property states, under which the separate property of a spouse is treated as "quasi-community property" at the divorce and [in some states] at the death of a spouse.) When a couple domiciled in a common-law state buys property in a community property state or vice versa, the character of the property is determined by the character of funds used to acquire it.

Those are only general rules, however. For real property, the general doctrine of lex situs applies. Courts in common law property states usually refuse to apply community property principles in deciding issues related to the ownership of real property in the common-law state. The community character of funds used to purchase real property in common law property states is recognized, but the courts often find that the spouses own such property as tenants in common in the common law property state rather than as community property. In contrast, courts in community property states have occasionally held that real property located in a common law property state is community property despite the lex situs principle. (Tomaier v. Tomaier in California and Zeolla v. Zeolla in Maine.)

b. ***Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA").*** Fourteen states have enacted the 1971 Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA") (Alaska, Arkansas, Colorado, Florida, Hawaii, Kentucky, Michigan, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming). The UDCPRDA generally provides that imported property that was originally community property remains community property for purposes of testamentary dispositions—meaning that a deceased spouse can dispose of one-half such property.

Any property held by a married couple as tenants by the entirety or by another form of joint ownership with right of survivorship is presumed not to be community property, even if the community property state whether property was acquired treats the property as community property with rights of survivorship. Under UDCPRDA, (1) the personal representative has no fiduciary duty to discover whether property is community property, and (2) the surviving spouse has no elective share, dower, or curtesy rights in property subject to the act.

UDCPRDA applies to testamentary dispositions of property and is not a tax statute. There is no federal income tax authority as to whether the characterization of property as community property under UDCPRDA will qualify for the basis adjustment of both halves of community property under §1014(b)(6). Planners typically report property located in a non-community property state as community on the federal estate tax return if it can be adequately traced to community property.

c. ***Effect for Divorce Purposes.***

Community Property States. The impact of migrating on property rights for divorce purposes varies among the community property states. In Idaho and Nevada, the law of the state where the property was acquired determines character and division of the property. In Washington and Wisconsin, statutes provide that all or nearly all of the property is divided equitably upon divorce. Arizona, California, Louisiana, New Mexico and Texas recognize "quasi-community property" for divorce purposes. Quasi-community property is property acquired while the married couple was domiciled in a common law state that would have been community property if they were domiciled in a community property state when it was acquired. Upon divorce quasi-community property is divided equally or equitably (depending upon the state) between the spouses.

Common Law States. The majority of states classify and divide all property under the law of the forum. A minority of states classify property using foreign law where the property was acquired but divide property under the law of the forum.

d. ***Effect for Death Purposes.***

Community Property States. Some community property states (California, Idaho, Louisiana, Washington and Wisconsin) adopt the quasi-community property system for division of property at death as well as upon divorce. The non-owner surviving spouse has community property rights, but has no elective share, dower or curtesy rights in the decedent's one-half portion of the quasi-community property. In the other community property states (Arizona, Nevada, New Mexico and Texas), there is no law requiring a deceased spouse's common law property to be shared with a surviving spouse. Therefore, for example, if a couple moves from Missouri to Arizona, the spouse who has no property could be disinherited. All property brought into Arizona would be treated as common law property of the spouse who owned the property and there is no effective mechanism to award the other spouse with any of that property upon the death of either spouse.

Common Law States. Common law property states have elective share and forced share laws to protect the surviving spouse. (Some states protect only property passing under a will and others protect property passing under a will or revocable trust.)

4. PLANNING STRATEGIES FOR MIGRATING CLIENTS

a. ***Advice Required.*** Planners will need to advise migrating clients regarding the property rights of each spouse, whether spousal agreements or waivers exist, the tax consequences of property characterization, and how rights are affected on divorce or death.

b. ***Planners Often Blindsided.*** Planners are usually familiar with only one property system, and they may be blindsided by other property systems. For example, common law property state planners tend to unwind community property without considering the impact of doing so, or just ignore community property. As an example of problems that can arise, clients may lose the benefit of the double basis step up or the possibility of fractionalization discounts at the death of a spouse if the planner fails to recognize community property owned by the spouses.

c. ***Ask Clients If They Have Moved.*** Planners should routinely ask clients if they have ever moved, and particularly if they had ever lived in a community property state. The clients may not realize that they own community property. An extended residence in a community property state will often indicate the presence of community property, particularly in light of the presumption favoring community property.

d. ***Maintain Inventory and Records.*** Migrating clients should maintain an inventory of their assets and records sufficient to trace the source of funds used to acquire their property.

e. ***Avoid Commingling.*** Establish separate accounts for community property and separate property, or use revocable trusts to hold separate and community property. Avoid commingling separate and community property assets in order to avoid tracing complexities.

f. ***Request Marital Agreements.*** Marital property agreements are more common in community property states than in common law states. "Double-pronged" agreements typically say that all currently-owned property is community property except for scheduled separate property, and that all future acquired property will be community property. (A "triple-pronged" agreement may also add that the deceased spouse's share of community property passes automatically upon a spouse's death to the surviving spouse without probate. That type of agreement may raise problems in being able to fund credit shelter trusts.)

g. ***Foreign Spouses Often Have Agreements.*** In many countries spouses typically have a marital property agreement prepared by a notary, adopting either a community property regime or a separation regime. Those agreements are respected in the United States for property and tax law purposes. Therefore, the client may never have lived in a community property state in America, but the agreement may state that they have elected to have a community property regime for their entire marriage. If a foreign agreement adopted a separate property regime, does that conflict with the strong presumption in favor of community property in U.S. community property states? California opinions have diverged on that issue. New York and New Jersey cases generally have followed those agreements. Florida opinions generally have not recognized them.

h. ***Confirm or Change Property Character.*** Planners should address whether the character of property should be confirmed or changed by agreement, conveyance or partition, and should address the impact of property characterization upon property rights and spousal expectations. If clients want to confirm the character of property, the law of the domicile where the property was acquired is generally used. If clients want to change the character, consider using the state under the choice of laws provision that will uphold the agreement. Beware that interspousal agreements have tax consequences and ethical issues (joint representation may be possible with adequate disclosures, but there are potential conflicts of interest because property rights may be altered).

The character of property can be memorialized in an agreement, or by segregating property in revocable trusts that specifically identify property in the trust either as separate property of a spouse or as community property.

i. **Reasons That Changing Character of Property May Be Desirable.**

Basis Adjustment at Death. For appreciating property, the community property character is desirable so that all of the property will receive a stepped-up basis. For depreciating property, converting community property to separate property of the more healthy spouse may be desirable to avoid a basis step-down at the first spouse's death.

Income From Separate Property. Income from separate property is community property under the laws of Idaho, Louisiana, Texas and Wisconsin. The clients may want to switch so that income from separate property is separate property in order to avoid commingling and tracing complexities.

Potential Disinheritance. Couples moving from a common law property state to Arizona, Nevada, New Mexico or Texas may leave no property protection for the non-owner spouse at death, because those states do not recognize the quasi-community property system at death. Those spouses may consider changing the character of property to community property by agreement so that a spouse has protected property rights.

j. ***Revocable Trusts.*** Joint revocable trusts have been more common in community property states than in common law states. Community property contributed to a joint revocable trust will be recognized as community for tax purposes (including the ability to take advantage of the "double basis step-up" under 1014(b)(6)) as long as it is still recognized as community property under state law. Rev. Rul. 66-283. Contributing property to a revocable trust may not be sufficient to change the character of the property. For example in Katz v. United States, 382 F.2d 723 (9th Cir. 1967), the contribution of community property from husband and wife to husband's revocable trust did not change the property to the separate property of the husband because the community property presumption was not overcome.

k. ***Be Careful Before Acquiring Title as Tenants by the Entirety or Joint Tenancy.*** Couples moving from community property to common law property states should generally avoid taking title to assets with community property proceeds as tenants by the entireties or as joint tenants with rights of survivorship. Those designations are generally inconsistent with community property ownership.

l. ***Gifts of Community Property.*** Gift splitting is not needed for gifts of community property assets—they are treated as gifts one-half by each spouse. Gifts of community property often require the consent of both spouses. Do not make a gift of community property to a trust in which a spouse is a beneficiary if the desire is to exclude the trust asset from the gross estates of the spouses. The beneficiary-spouse will be treated as making a gift of one-half of the assets with a retained beneficial interest subject to §2036(a)(1).

m. ***Beneficiary Designations.*** Be cautious before naming someone other than the spouse as beneficiary of a community property life insurance policy or IRA. The non-insured/non-participant spouse may be treated as making a gift of one-half of the community property asset.

n. ***Be Aware of Quasi-Community Property Rules if Clients Move to Community Property State.*** Inequities could result for couples moving from a common law property state to a community property state with one spouse owning most of the assets. The elective share and forced share rules designed to protect spouses would not apply because they do not exist in community property states. However, such property may be treated as community property if the state recognizes the quasi-community rules for proposes of property rights at death.

Items 5-9 are observations from a seminar by Karen E. Boxx, Louis S. Harrison, and Robert K. Kirkland, The Good, the Bad, and the Innovative: The Evolution of Joint Spousal Trusts in Today's Estate Planning

5. General Types of Joint Trusts

There are three general types of joint trusts: (1) community property joint trusts, with scheduled separate property and community property assets (used in community property jurisdictions), (2) equal property trusts in common law property states (with both spouses contributing equally and having equal rights to assets in the trust); and (3) joint trusts with a general power of appointment given to the first spouse-to-die over all property in the trust.

6. Benefits of Joint Trusts

a. ***Easy to Understand.*** Having a single joint trust is easier for clients to understand than having each spouse create his or her own trust, with multiple successor trusts being created under each of those trust agreements.

b. ***Avoiding Facing a Split of Assets.*** Clients feel more comfortable seeing both of their names on the trust property, rather than splitting property between two separate trusts, raising the issue of unequal trusts or having interspousal transfers before the trusts are created.

c. ***Funding Credit Shelter Trusts***. Giving the first spouse to die a broad general power of appointment over all property in the trust can facilitate being able to fund fully the credit shelter trust at the first spouse's death without having to worry about allocating assets between the spouses so that the first spouse to die owns sufficient assets to fund the credit shelter trust fully. (This issue discussed below in more detail.)

d. ***Full Basis Step-Up.*** Using the joint trust with a general power of appointment for the first spouse to die over all of the trust assets provides an argument that all of the trust assets should receive a basis adjustment at the first spouse's death.

7. Qualified Spousal Trusts

a. ***Overview***. The qualified spousal trust is a way of transferring tenancy by the entireties property to a revocable trust and retaining the favorable characteristics of tenancy by the entireties. Cases in two states have recognized the concept, and a few states have now recognized the concept by legislation.

b. ***Tenancy by the Entireties.*** Tenancy by the entireties is a unique form of ownership permitted between spouses. The couple is considered to own the whole of the property, and neither spouse can dispose of the property acting alone. Two key features are: (1) the surviving spouse has a right of survivorship at the death of the first spouse; and (2) creditors of an individual spouse cannot attach the property. The concept is recognized in 26 states, eight of which have legislation that recognize qualified spousal trusts as being able to hold tenancy by the entireties property.

b. ***Cases.*** Pennsylvania was the first state to recognize the concept by case law in a 1943 Pennsylvania Supreme Court case (*In re: McEwen's Estate*), but the reasoning of that case was based on a now obsolete concept. Forty-two years later, a Missouri case recognized that spouses could transfer assets to a joint trust and have the assets treated as tenancy by the entireties property. *Bolton Roofing Company, Inc. v. Hedrick* (Mo. App. 1985). A case in Hawaii rejects the concept (though it is now recognized by statute in Hawaii). Cases in Florida are not clear as to whether they recognize the concept, and some Florida practitioners maintain that there is too much risk in relying on the concept without clear recognition that transferring tenancy by the entireties property to the trust would not destroy the advantages of entireties ownership.

c. ***Statutes.*** The Commonwealth of Virginia was the first state to recognize qualified spousal trusts in 2001. The concept has now been adopted by statutes in Delaware, Maryland, Indiana, Illinois, Missouri, and Hawaii. Tennessee is now considering a legislative proposal.

d. ***Requirements.*** The requirements vary among the states. The Virginia statute recognizes that spouses can transfer tenancy by the entireties property to a revocable trust and retain the creditor protection that applies to entireties property if "(1) they remain husband and wife, (2) it continues to be held in the trust or trusts, and (3) it continues to be their property." Some statutes require that the statute be cited. Some but not all states expressly require that the property be held as tenancy by the entireties property before it is transferred to the trust. All of the statutes allow splitting the trust into two separate shares while the spouses are living (so the trust could say that one-half of the property is held in husband's trust and one-half is held in wife's trust). That permits continued creditor protection even though each spouse would then have control over the ability to dispose of his or her one-half share. Most of the states (not Hawaii) also seem to allow splitting the deceased spouse's one-half share at the death of the first spouse, which allows protection against creditors for assets left to a credit shelter trust for the survivor (whereas with a regular tenancy by the entireties property, all of the assets pass to the surviving spouse by survivorship and remain exposed to the survivor's creditors).

8. Detriments of Joint Trusts

a. ***Divorce.*** Spouses are the most likely creditors of almost all clients (50% of marriages end in divorce). In community property states joint trusts typically have schedules detailing the trust assets that are owned as community property and the trust assets that are the separate property of each of the spouses. In common law property states, joint trusts typically do not have schedules and disputes arise at divorce as to whether assets in joint trusts are owned equally by the spouses, or whether the propertied spouse did not intend to make a gift to the non-propertied spouse by making a contribution to the trust. For this reason, joint trusts in common law property states should be combined with an intent agreement.

b. ***Creditor Protection.*** In community property states, creditors generally have the same access to property in joint trusts as they would have to property owned directly by the spouses (because the schedules detail the assets owned by each spouse). In common law property states, however, the creditors of either spouse can usually reach all of the trust assets. That can usually be avoided by using separate trusts for each spouse's assets.

9. Tax Issues With Joint Trusts.

a. ***Completed Gift on Funding of Joint Trust?*** Completed gift issues can arise even though the joint trust is revocable.

In community property states, if the assets will pass to or for the benefit of the surviving spouse at a spouse's death and if spouses must act jointly to revoke the trust, there may be a completed gift upon creating the trust because the trust could be revoked only with the consent of a person who has a substantial adverse interest (Reg. § 25.2522-2(e)), and that causes a completed gift under the gift tax regulations. The older spouse may be treated as making a gift to the younger spouse that would not qualify for the marital deduction (because it would be a terminable interest without a mandatory income interest). Typically, joint trusts with community property provide that either spouse may unilaterally revoke the trust as to all community property held in the trust (i.e., both halves of community property). (The community property would be subject to the same ownership and management rights, but the trust layer would have been removed.)

The Uniform Trust Code states that for revocable trusts holding community property, "the trust may be revoked by either spouse acting alone but may be amended only by the joint action of both spouses." (§602(b)).

In common law property states, joint trusts often state that the contributions are treated as if made one-half by each spouse, that on revocation one-half of the trust assets would pass to each spouse, and that if a distribution is made to one spouse, an equal distribution is made to the other spouse.

b. ***Estate Tax and Basis Effect for Community Property in Joint Trust.*** Rev. Rul. 66-283 confirms that community property in a revocable trust is respected as community property at the death of the first spouse to die—one-half of the community property trust assets are included in the decedent's gross estate and the basis adjustment applies to both halves of the community property.

c. ***Impact on Funding Credit Shelter Trust***. If the joint trust provides that a credit shelter trust is funded for the surviving spouse at the first spouse's death, §2036(a)(1) may cause estate inclusion in the estate of the surviving spouse if the surviving spouse is treated as a contributor to the credit shelter trust. Therefore, joint trusts must be drafted to make clear that only the decedent-spouse's portion of assets in the joint trust is being used to fund the credit shelter trust. (The trust could also specify that the surviving spouse's portion of the trust assets remain in the trust, and the surviving spouse could be the trustee of those assets with full right to amend or revoke the trust as to his or her assets in the trust.)

d. ***Funding Credit Shelter Trust from Qualified Spousal Trust***. Some states permit a qualified spousal trust (QST) to split the decedent-spouse's one-half share into separate trusts after the first spouse's death. The Missouri statute allows such a division, and the Illinois and Maryland statutes do not. The legislation in the other QST states appear to allow such division by implication. Such a funding approach is very advantageous. It allows the administrative convenience of being able to use the QST assets to be used to fund the credit shelter trust. With this approach, a couple could hold much if not most of their marital assets in a QST with the creditor protection afforded tenancy by the entireties property. Furthermore, following the first spouse's death, the assets left to the credit shelter trust would have spendthrift protection from the surviving spouse's creditors, as compared to the general rule that entireties property passes by survivorship to the surviving spouse and therefore both halves of entireties property would be subject to claims of the surviving spouse's creditors.

e. ***General Power of Appointment Over All Joint Trust Assets to Facilitate Funding Credit Shelter Trust.*** Several private letter rulings, and in particular PLR 200101021 provide that giving the first decedent-spouse a general power of appointment over all of the joint trust assets is workable to facilitate funding the credit shelter trust at the first spouse's death. This is not as important now that portability is available to avoiding wasted the first decedent-spouse's unused estate exemption. For spouses that wish to fund a credit shelter trust at the first spouse's death, however, this planning can be very helpful to facilitate having sufficient assets to fund the trust even if the "non-propertied" spouse dies first.

   In PLR 200101021, the joint trust was funded with tenancy by the entireties property. Each spouse could terminate the trust, causing the trust property to be delivered to the grantors as tenants in common. Upon the death of the first grantor, he or she had a testamentary general power of appointment over the entire joint trust. In default of exercise of the power of appointment, a credit shelter trust was to be funded with the trust assets, with the balance of the trust assts passing to the surviving spouse.

   No completed gift on creation of joint trust. The IRS held that no completed gift occurred upon funding the trust because each spouse had the power to terminate and receive back the one-half of the assets that was contributed by that spouse. (If unequal contributions were made to the trust by the spouses, the trust should make clear that upon revocation by either spouse, the spouses would receive their contributions to the trust.)

Includability in first spouse's estate. Because the first decedent-spouse has a general power of appointment over all trust assets, the entire trust estate is included in the first spouse's gross estate.

No §2036 problem for credit shelter trust. Because all of the assets are in the first decedent-spouse's gross estate, the assets that fund the credit shelter trust are deemed to come entirely from the decedent-spouse, not from the surviving spouse's interest in the trust. In effect, the surviving spouse makes a gift to the decedent-spouse of his or her interest in the trust immediately at death, which the decedent-spouse uses to fund the credit shelter trust. Therefore, §2036 will not apply.

No taxable gift from surviving spouse to first decedent-spouse. The ruling reasons that the decedent-spouse's broad general power of appointment results in a relinquishment of control by the surviving spouse and is a gift from the surviving spouse to the decedent-spouse. (Some commentators speculate that the IRS reasoned that a gift occurred, so that the immediate post-death transfer to the surviving spouse occurred within one year of the immediate pre-death gift, so that §1014(e) applies to deny a basis step-up on all joint trust assets, as discussed in paragraph f immediately below.) The gift qualifies for the gift tax marital deduction, however, according to the IRS. Some commentators have questioned whether this deemed gift and gift tax marital deduction ruling is correct, and some planners are uncomfortable using this technique without further clarification. The IRS is not attacking them, however.

f. ***General Power of Appointment Over All Joint Trust Assets to Obtain Basis Step-Up on All Joint Trust Assets.*** The IRS ruled that §1014(e) applies**,** reasoning that assets are given from the surviving spouse to the decedent-spouse and then returned to the surviving spouse within one year of the gift, therefore no basis adjustment is permitted under §1014(a). Arguably, §1014(e) does not apply if the assets do not return "to" the donor (i.e., the surviving spouse) but remain in trust for the benefit of the surviving spouse. Also, some commentators question the IRS's reasoning that the surviving spouse makes a gift at the instant of the first spouse's death as a result of relinquishing control to the decedent-spouse. In any event, the IRS position is clear that a basis adjustment is allowed only for the portion of the joint trust assets attributable to the first decedent-spouse's contributions to the trust, and most planners are not claiming the full basis step-up for all property in the joint trust in light of the IRS's position in these PLRs.

Items 10-18 are observations from a seminar by Thomas W. Abendroth and Barbara A. Sloan, Planning With Portability: When It Isn't Potable

10. Brief Background

Section 303(a) of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("the 2010 Tax Act") allows portability of any unused "basic" exclusion amount (changed to "applicable" exclusion amount in ATRA) for a surviving spouse of a decedent who dies after 2010 if the decedent's executor makes an appropriate election on a timely filed estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount" (referred to in the regulations as the "DSUE amount.") The surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse."

The portability election must be made on a timely filed return (which the portability regulations state to be nine months after date of death due date that generally applies if the estate is required to file an estate tax return, or the extended due date if a timely extension request is filed). Filing an estate tax return is deemed to make the portability election unless the executor elects out of making the portability election. There are simplified reporting procedures, eliminating the requirement to list the values of assets passing to the surviving spouse or charities in most cases. If the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, 9100 relief is available, but that requires a formal PLR request and is expensive.

11. Portability Decision Can Be Complex

Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. From the planner's perspective, this is a more complex decision involving a wide variety of factors. Although the purpose of portability is to facilitate simplicity for clients, the possibility of relying on portability may in some cases make the planning process more complicated, and may make it more difficult to communicate fully to clients the advantages and disadvantages of planning alternatives.

12. Reasons Favoring Using Bypass Trusts Even With Portability

There are various reasons that may favor using bypass trusts at the first spouse's death and not relying on the portability provision including:

(a) the deceased spousal unused exclusion amount is not indexed;

(b) growth in the assets are not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust, which is excluded;

(c) there is no portability of the GST exemption;

(d) there is no statute of limitations on values for purposes of determining the unused exclusion amount that begins to run from the time the first deceased spouse's estate tax return is filed, whereas the statute of limitations does run on values if a bypass trust is funded at the first spouse's death;

(e) the "ported" exemption is lost if the surviving spouse remarries and the new spouse also predeceases with little unused exclusion;

(f) if the decedent-spouse had received unused exclusion from a prior deceased spouse, at the decedent-spouse's death the "inherited" exclusion amount cannot be "ported" to the surviving spouse to the extent that the decedent-spouse's unused exclusion amount exceeds the basic exclusion amount at the decedent-spouse's death;

(g) the state exemption amount (in decoupled states) is not portable, so at a minimum the client may want to fund a bypass trust with the amount of the state exemption (discussed in more detail below);

(h the bypass trust could be funded with discounted hard to value assets when there may be a low audit risk at the first spouse's death;

(i) using a bypass trust can avoid substantial inequities that might otherwise occur in a blended family situation (in which at least one spouse has children by a prior marriage—discussed in more detail below); and

(j) there are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse (although those benefits can also be utilized with portability by using a QTIP trust with a full QTIP election rather than a bypass trust).

13. Reasons Favoring Portability

There are some situations in which planners may strategically decide that relying on portability is better than creating credit shelter trusts in the first decedent-spouse's will. Situations favoring an approach leaving all of the assets outright to the surviving spouse or to a QTIP trust and relying on portability include:

(a) a strong desire for simplicity (some clients just "mistrust trusts");

(b) a competent spouse who can manage assets and for whom the non-tax advantages of trusts are not perceived to be significant (suggesting an outright bequest);

(c) a first marriage or no children existing by a prior marriage of either spouse;

(d) clients who are more interested in basis step-up than getting future appreciation out of their estates;

(e) there is a residence or other assets that would be difficult to administer in a trust;

(f) there is a significant likelihood that net consumption or depreciation in estate assets might occur (which would mean that the surviving spouse would be better off having the full unused exclusion amount rather than merely having the depreciated bypass trust excluded from the estate);

(g) qualified retirement plans are a major portion of the estate and there is no way to fund a bypass trust fully without using the retirement or IRA benefits (or other income in respect of a decedent assets) in light of the fact that leaving qualified plan benefits outright to the surviving spouse results in the greatest flexibility in deferring required minimum distributions from the plan and the fact that the payment of income taxes from the plan benefits may make it likely that these types of assets will depreciate prior to the surviving spouse's death, thus invoking the advantage in subparagraph (f) above;

(h) retitling of assets from the propertied spouse to the less propertied spouse (to have sufficient assets to fund the bypass trust fully if the non-propertied spouse dies first) can be avoided; the additional administrative and income tax costs of having assets in trust may outweigh the potential tax and non-tax advantages of trusts;

(i) for very wealthy estates, if the spouse does not need any income or principal from the property that would fund the credit shelter trust, the surviving spouse can make a gift that is covered by the DSUE amount that would be a grantor trust as to the surviving spouse, thus allowing utilization of the first decedent-spouse's estate exclusion amount in a trust that is a grantor trust as to the surviving spouse; and

(j) achieving a double basis step-up (at both spouses' deaths) *and* making use of the first decedent's GST exemption may be possible by using a QTIP trust, making the "reverse QTIP election" allocating the first decedent's GST exemption to the trust, and making the portability election.

14. Significant Potential Inequities With Blended Family Situations

In a blended family situation, substantial inequities may result if the credit shelter approach is not used.

Potential problems can arise if there is hostility between the executor (perhaps a child by the decedent's prior marriage) and the surviving spouse's family. The executor may try to "extort" consideration for making the portability election. Or the executor may be unwilling to bear the expense of filing an estate tax return to make the election. (The will could be drafted to provide that the executor would not be required to make the portability election unless the surviving spouse pays the expenses of filing the estate tax return.)

If assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first decedent-spouse's descendants (or may favor some over others of those descendants in ways that the decedent-spouse would not have wanted). Even if a QTIP trust is used, the surviving spouse may be able to take steps that would significantly disadvantage the decedent-spouse's descendants—despite having the assets "protected" in a QTIP trust.

QTIP Trust "overpaying" estate tax. The assets of the QTIP trust will be included in the surviving spouse's gross estate, and the surviving spouse's estate is entitled to reimbursement under §2207A for estate taxes attributable to the QTIP trust (determined on a marginal basis: the amount of estate taxes with the QTIP trust included in the gross estate minus the amount of federal estate tax if the QTIP trusts were not included in the gross estate). This could occur if the surviving spouse makes gifts utilizing the DSUE amount or even if the spouse makes no gifts but has his or her own assets that are large enough to cause the payment of estate taxes even if the QTIP trusts were not included in the estate.

For example, assume W dies with $2 million passing to a QTIP trust. H later dies with his own $12 million estate. H's gross estate is $14 million. H's estate exemption is $5.25 million DSUE from W + H's $5.25 million (assuming no indexed increase in the exemption), or $10.5 million. The federal estate tax is ($14 million - $10.5 million) x 40%, or $1.4 million. If there were no QTIP trust, H's estate tax would have been ($12 million - $10.5 million) x 40%, or $600,000. The difference ($1.4 million - $600,000) or $800,000 must be borne by the QTIP trust (unless H waives his reimbursement right under §2207A). W's children have to bear $800,000 of the estate tax even though her estate was well under her $5.25 million exemption amount.

Possible planning alternatives to avoid this situation are (i) use a premarital or post-nuptial agreement in which the parties agree that a decedent-spouse's executor will make the portability election only if the surviving spouse agrees to waive the §2207A reimbursement right from the decedent-spouse's QTIP trust, or (ii) if a marital agreement is not possible, the decedent-spouse's executor might agree to make the portability election only if the surviving spouse agreed to waive the §2207A reimbursement right. (Agreeing to make the QTIP election only if the surviving spouse agreed to waive the reimbursement right might conceivably create concerns as to whether the QTIP election was valid, and using the conditional portability election is preferable to a conditional QTIP election.)

QTIP Trust "underpaying" estate tax. Reverse fact scenarios could arise in which the surviving spouse's family would be disadvantaged and pay more than their fair share of the estate tax due at the surviving spouse's death if the surviving spouse waives the reimbursement right.

For example, assume W dies with $12 million passing to a QTIP trust. H later dies with his own $8.5 million estate. H's gross estate is $20.5 million. H's estate exemption is $5.25 million DSUE from W + H's $5.25 million (assuming no indexed increase in the exemption), or $10.5 million. H's federal estate tax is ($20.5 million - $10.5 million) x 40%, or $4 million. If there were no QTIP trust, H's estate tax would have been ($8.5 million - $10.5 million) x 40%, or $0. H's agreement to waive his §2207A reimbursement right means that his estate bears $4 million of the estate tax—and his family only receives $4.5 million of his $8.5 million estate. If the $4 million of estate tax were prorated between the QTIP trust and H's estate, the QTIP portion would be $2.34 million ($4 million x 12/20.5) and H's estate portion would be $1.66 million ($4 million x 8/20.5).

Accordingly, in a complex blended family situation, consider not using portability at all, but using a bypass trust. Alternatively, if the family wishes to use the portability approach, fund the first decedent-spouse's assets exempt amount into a separate QTIP trust and have the surviving spouse agree to waive reimbursement rights with respect to that trust only.

15. Factors Impacting Bypass Trust vs. Portability Decision

Some of the family factors that will be considered in making the portability decision include:

(a) size of the estate (an estate that is well under the amount of combined exemptions will be more inclined to use portability; for example if the combined estate is $5 million, it is extremely unlikely that the combined estate at the surviving spouse's death would incur a federal estate tax, and being able to take advantage of the second basis step-up may be of paramount importance);

(b) ages of the spouses (the spouses will be more comfortable relying on portability if they are age 70 rather than age 45);

(c) occupation (impacting whether substantial future growth in the estate is likely);

(d) state of residence (suggesting that a bypass trust may be needed up to the amount of the state estate tax exemption); and

(e) an analysis of capital gain taxes vs. estate tax costs (realizing that if there is a reasonable amount of turnover in the estate portfolio assets there may not be a substantial amount of unrealized appreciation at the second spouse's death in any event).

16. Revenue Procedure 2001-38

Some have questioned whether Rev. Proc. 2001-38, 2001-1 CB 1335 precludes the use of QTIP trusts in connection with a portability election. It provides that the IRS will ignore a QTIP election "where the election was not necessary to reduce the estate tax liability to zero." Particularly if the estate is below the exemption amount, the QTIP election clearly is not necessary to reduce the estate tax liability to zero. However, for various reasons Rev. Proc. 2001-38 does not appear to preclude making a QTIP election even though the estate is relying on portability. *See generally* Franklin, Law & Karibjanian, Portability — The Game Changer (January 2013), available on the American Bar Association Real Property Trust & Estate Law Section website.

The IRS has added "the validity of QTIP elections on an estate tax return filed only to elect portability" as an item on the IRS/Treasury Priority Guidance Plan for 2013-2014. Ron Aucutt believes that the inclusion of this item on the Priority Guidance Plan makes clear that the IRS will grant relief from Rev. Proc. 2001-38 in the context of estates making the portability election. Aucutt, *ACTEC Capital Letter No. 34, Priority Guidance Plan Published, Commissioner Nominated* (Aug. 12, 2013)("Clarifying that result is evidently what this new item on the Priority Guidance Plan is about. It is not always the case that the appearance of a project on the Priority Guidance Plan makes it clear what the outcome of the project will be, but it is clear in this case.").

17. Creating Grantor Trust as to Surviving Spouse

Leaving assets to the surviving spouse or QTIP and using portability allows the surviving spouse to makes gifts using both spouses' exemption amounts and that full amount can pass to a trust that is a grantor trust as to the surviving spouse. For this purpose, portability may be desirable even for very large estates. A further advantage of this approach, as compared to funding a bypass trust at the first spouse's death, is that minority discounts may be larger if the gift is made to multiple trusts for multiple beneficiaries. If this advantage may apply in a particular case, and if the QTIP approach is used to leave the surviving spouse the flexibility of making the portability decision, the QTIP trust should give some third party wide discretion in making principal distributions to the surviving spouse, which the spouse could then use to make the gifts.

This strategy is available only for a very wealthy family, for which the surviving spouse can afford to make a $5+ million gift after the first spouse's death. As a practical matter, most estates of that size have very likely already made use of the spouse's gift exemption amounts during life. Another difficulty is that the decedent-spouse must be willing to leave the assts outright to the spouse (or use a QTIP trust with very broad distribution flexibilities.) An obvious disadvantage of this strategy is that the spouse would not be able to be a discretionary beneficiary of the gifted assets. A further practical concern with this approach is that the surviving spouse may decide not to "pull the trigger" in making the gifts. Also, there is a concern about whether the surviving spouse will be competent to make the gifts following the first spouse's death. A broad power of attorney authorizing large gifts would seem appropriate with this strategy and persons holding that power of attorney may be uncomfortable making those kinds of large gifts.

18. State Estate Tax Planning Implications of Portability

Using a credit shelter trust for the full amount of the federal exemption amount at the first spouse's death might generate significant state estate taxes, which could be avoided by using portability. For example, fully funding a bypass trust in New York, with its $1 million exemption amount, would cost about $420,800 in New York state estate tax at the first spouse's death. Perhaps a bypass trust would be funded with only the amount of the state exemption. In addition, if bequests are made outright to the surviving spouse, the surviving spouse could make gifts, which are not subject to state estate or gift taxes in most states. Only two states (Connecticut and Minnesota) have a gift tax, and a few more have "contemplation of death" state estate tax provisions for transfers within a certain period of time prior to death.

Delaware has adopted a portability concept for its state estate tax. The Delaware tax provision makes reference to the federal "applicable exclusion amount" (which includes the DSUE amount).

State estate tax implications for clients who have made substantial prior gifts. If an individual has made significant lifetime gifts, the amount that can be funded into a bypass trust at the individual's death without imposing a state estate tax may be relatively insignificant. Of the 20 states (including the District of Columbia) that impose a state estate tax, many of them calculate the state tax as a pick-up or modified pick-up regime calculated as if the federal law were frozen prior to the repeal of the state death tax credit, and specifying the federal applicable exclusion amount to be used in the calculation—in some cases, $1 million (which applies in New York) or less. The state death tax credit under §2011(b) applies a graduated rate table to the "adjust taxable estate," defined as the "taxable estate" reduced by $60,000, and the table applies only where the adjusted taxable estate exceeds $40,000. Therefore, the first $100,000 of the taxable estate is excluded from the credit. In effect, this means that the bypass trust could always be funded with $100,000 without generating any state estate taxes. The state death tax credit cannot exceed the tentative federal estate tax reduced by the applicable credit under §2010.

Wills typically direct funding of the bypass trust in an amount that will not generate any federal or state estate taxes. If the individual has made substantial prior gifts, that clause may result in only $100,000 passing to the bypass trust.

For example, assume an individual has previously made $5 million of taxable gifts and dies in 2013 as a resident of New York when the federal gift exclusion amount has grown to $5.25 million, leaving $250,000 unused. Because the prior gifts have already exceeded $1 million, the $1 million "exemption" for state purposes becomes meaningless. The formula would operate to leave $100,000 to the credit shelter trust; that is the only amount that can pass to the trust without paying state estate tax. The remaining $150,000 (of the $250,000 available federal exemption amount) could be left to a $150,000 state QTIP trust.

To avoid the creation of such small trusts, removing the formula credit shelter bequest from the will may be prudent, and allow any unused applicable exclusion amount to pass to the surviving spouse with a portability election.

Clients in non-tax states owning real estate in decoupled states. Clients living in states without state estate taxes may nevertheless have to pay state estate tax if they own real estate in states that have a state estate tax. This may be the case even if the real estate in the other state does not exceed the exemption for that state; many states calculate the state estate tax that would apply on the entire estate, wherever located, and impose a tax that is proportionate to the amount of the estate represented by the in-state real property.

All to H. Assume W dies in Florida with a $4 million estate, including a $1.5 million New York condo. Assume W leaves all of the estate to H, and makes the portability election. H dies soon thereafter (before any appreciation occurs) with an estate of $6 million (including $2 million of his own assets). H's available exemption (including the $5.25 DSUE amount from W) far exceeds his $6 million estate and he owes no federal estate tax. The New York tax on the full $6 million estate would be $510,800. The ratio of New York assets to total assets in the gross estate is 1.5/6.0, or 25%. The New York tax is $510,800 x 25%, or $127,700.

W funds $1.0 M CST with non-New York assets. Same facts but assume W leaves $1 million to a credit shelter trust (CST). She owes no federal or state estate tax. H dies with a $5 million gross estate (his $2 million + $3 million from W). H's available exemption (including the $4.25 DSUE amount from W) far exceeds his $5 million estate and he owes no federal estate tax. The New York tax on the full $5 million estate would be $391,000. The ratio of New York assets to total assets in the gross estate is now 1.5/5.0, or 30%. The New York tax is $391,000 x 30%, or $117,000. Therefore, there is only a small savings by W's funding the $1 million CST at her death with non-New York assets.

*W fund $1.*0 M CST *with New York property*. Same facts but assume W leaves $1 million of the $1.5 million condo into a CST. She owes no federal or state estate tax. H dies with the same $5 million gross estate as in the prior example and owes no federal estate tax. The New York tax on the full $5 million estate would be $391,000. The ratio of New York assets to total assets in the gross estate is now only $500,000/$5,000,000, or 10%. The New York tax is $391,000 x 10%, or $39,100. Substantial savings result from funding the CST with an interest in the New York property.

W fund CST with all New York property. Same facts but assume W leaves the entire $1.5 million New York condo to a CST. She owes no federal tax, but now she owes a New York state tax (because she funded the CST with more than $1 million). The New York tax would be $64,400 on the full $1.5 million; the New York property percentage of the gross estate is 1.5M/4M, or 37.5%, so the New York tax is $24,000. That is paid out of the marital share so an interrelated calculation is required, which increases the New York tax to $24,744. H dies with a $4.5 million gross estate (his $2 million + $2.5 million from W). H's available exemption (including the $3.75 DSUE amount from W) far exceeds his $4.5 million estate and he owes no federal estate tax. There are no New York assets in his gross estate, so he owes no New York state tax. In this example, the best result is from fully funding the CST with the New York property at W's death, even though that requires paying some state estate tax at the first spouse's death.

Items 19-24 are observations from a seminar by Barry A. Nelson and Daniel S. Rubin, How Does the Ethical Asset Protection Lawyer Sleep at Night? "Very Well, Thank You Very Much!"

19. Overview of General Importance of Asset Protection Planning in Estate Planning

Planners often think of "asset protection planning" as structuring assets to be beyond the reach of unanticipated creditors. But it is much more pervasive than that. For example, it includes acquiring real estate in some entity rather than directly in an individual's name, or transferring ownership of an auto to the name of a child upon reaching adulthood so that the parent may no longer have liability for auto accidents involving that auto merely because the parent owns the car. All planners are involved in asset protection.

This presentation addresses ethical issues and potential civil and criminal liability of planners.

20. Law of Fraudulent Transfers Overview

There are two types of fraudulent transfers: (1) Actual fraud, for which there is an actual intent to hinder, delay or defraud creditors—this is generally proven by reference to "badges of fraud;" and (2) Constructive fraud involving transfers made for less than reasonably equivalent value when the debtor is insolvent.

The Uniform Fraudulent Transfer Act (UFTA) refers to transfers made with the “actual intent to hinder, delay or defraud any creditor of the debtor.” § 4(a)(1).

a. ***Transfer Planning With Exempt Assets.*** “Transfer” is defined in the UFTA to mean every mode of disposing or parting with an asset. §1(12). Various cases have interpreted “assets” to exclude assets that are exempt from creditors’ claims; therefore transfers of exempt assets cannot be fraudulent transfers. *E.g.*, *Sneed v. Davis*, (Fla. 1938). That is a state law issue, and the planner should verify that the rule as to transferring exempt assets is the same in the planner’s jurisdiction.

   Planning Pointer: Assume H and W own tenancy by the entireties property and H has potential creditor issues. H might consider transferring the asset to W. That transfer should not be a fraudulent transfer because it is the transfer of an exempt asset. If W predeceases H, she could leave the asset into a spendthrift trust for the benefit of H.

b. ***Application of UFTA to Future Creditors.*** While the UFTA refers to “any creditor of the debtor” there is a long history distinguishing between existing creditors and reasonably anticipated creditors from those future creditors who were not, and perhaps could not, have been contemplated by the debtor at the time of the transfer (“potential future creditors”). The UFTA generally applies only to future creditors and not “future *potential* creditors” (where there was no foreseeable connection between the creditor and debtor at the time of the transfer).

   “While the Court finds it very difficult to locate the exact line between bankruptcy planning and hindering creditors, Congress has decided that the key is the intent of the debtor. If the debtor has a particular creditor or series of creditors in mind and is trying to remove his assets from their reach, this would be grounds to deny the discharge. If the debtor is merely looking to his future well-being, the discharge will be granted.” *In re Oberst*, (Bnkr. C.D. Cal. 1988).

   Various other cases have reasoned similarly. *E.g., First National Bank in Kearny v. Bunn* (Neb. 1976) (“made to defraud subsequent creditors whose debts were in contemplation at the time”); *Hurlbert v. Shackleton* (Fla. 1st DCA 1990) (trial court drew distinction between “probable” and “possible” future creditors; appellate court rejected that distinction but remanded the case for determinations of actual intent and emphasized that “where the creditor is not in existence at the time of the conveyance, there must be evidence establishing actual fraudulent intent”; strong dissent would have affirmed the trial court’s view that future malpractice victims could not establish actual intent).

Practical Pointer: Disputes may arise later as to whether a client informed the attorney of anticipated creditors' claims or of issues bearing on the debtor's insolvency. Have two attorneys sitting in the client conference, in case the client later points a finger at the attorney for advising a transfer when the effect is to obstruct an anticipated creditor.

c. ***Fraudulent Asset Conversion.*** Converting non-exempt assets into exempt assets to avoid creditor issues is generally referred to as fraudulent asset conversion. In the bankruptcy context, this is known as "pre-bankruptcy exemption planning." Converting non-exempt to exempt assets is not *per se* actionable fraud, but the creditor must prove actual intent to defraud creditors. *In re Levine* (Bankr. S.D. Fla. 1984). For example, *In re Reed* (5th Cir. 1983) found the existence of such actual intent when the debtor paid down the mortgage on his home two weeks before bankruptcy during an agreed-upon delay with a creditor.

21. Ethical Considerations

a. ***Model Code and Model Rules.*** California is now the only state that recognizes the Model Code of Professional Responsibility. Other states are governed by the subsequently promulgated Model Rules of Professional Conduct.

The Model Rules do not directly address asset protection planning or fraudulent transfers, but some of the provisions are relevant, including §8.4(c) ("engage in conduct involving dishonesty, fraud, deceit or misrepresentation"); §4.4(a) ("no substantial purpose other than to embarrass, delay, or burden a third person"); §1.2(d) ("shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is *criminal* or fraudulent").

The Model Code provision that was analogous to §1.2(d) of the Model Rules referred to "conduct that the lawyer knows to be *illegal* or fraudulent." The difference between "illegal" or "criminal" is extremely important.

There have been very few ethics opinions in the fraudulent transfer context, but there have been some cases.

b. ***Ethics Opinions. Connecticut Informal Opinion*** 91-22 (Dec. 5, 1991) reiterated that the Model Rules "do not apply to all illegal conduct but rather to conduct that is known to be criminal or fraudulent." *Ethics Opinion 1993-1 of San Diego County Bar Association* concluded that a lawyer could not ethically advise or assist clients in avoiding existing and identifiable creditors' rights. The State Bar of California Committee on Professional Responsibility and Conduct has at least twice declined similar ethics opinions, stating that it believes this issue is "primarily a legal matter rather than an ethics matter." *South Carolina Bar Ethics Advisory Opinion 84-02* held that transfers of a client's assets to protect against the potential claims of future creditors was ethical.

c. ***Cases.*** Various cases have held that advising clients to transfer assets to avoid existing creditors or likely creditors violated the respective state ethics rules. Several cases have so held even though no actual loss occurred, reasoning that such conduct is still unethical and unprofessional, is dishonorable, and brings the profession into disrepute. *E.g., In the Matter of Dante De Pamphilis* (N.J. 1959).

d. ***Ethical Obligation to Provide Asset Protection Advice.*** The Model Code and Rules suggest that the failure to provide a client with appropriate asset protection advice could be unethical. Model Code DR 7-101 (representing a client zealously); Model Rule §1.3, Comment [1] ("must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf").

Cases confirm that lawyers have a duty to inform clients of issues that the client may not have considered.

An asset protection treatise takes the position that "asset protection may be elevated to the domain of 'skill, prudence, and diligence as other members of the legal profession commonly possess and exercise,' thereby creating a duty on the part of lawyers to advise clients to engage in asset protection planning or to refer the client to another attorney qualified to do so." Spero, *Asset Protection*, Vol. 1, § 2.04(2) (Thomson/RIA 2008).

A written and signed engagement letter will permit the attorney to limit the scope of the representation. If the attorney is not addressing asset protection planning in an estate planning representation, the engagement letter should make that clear.

22. Civil Liability Concerns

a. ***Distinction Between Ethical Proscriptions and Civil Liability.*** The Preamble (Scope, § 20) to the Model Rules clarifies that the ethics rules in the Model Rules "are not designed to be a basis for civil liability…. Nevertheless, since the Rules do establish standards of conduct by lawyers, a lawyer's violation of a Rule may be evidence of breach of the applicable standard of conduct."

b. ***Legal Bases for Civil Liability.***

(1) *Malpractice.* Malpractice is based on the failure to exercise the care, skill and diligence that is commonly exercised by other attorneys practicing in similar situations. Specialists will normally be held to the higher standard of care to which legal specialists practicing in the same area would conform. A pending case in Florida is *Greiff v. Cahan and Becker & Poliakoff*. H was involved in a Madoff clawback action and the attorney (in return for a $44,000 flat fee) advised H to transfer $6 million (that he owned pre-marriage) to W pursuant to a post-nuptial agreement. W later filed for divorce; the court upheld the validity of the post nuptial agreement and allowed W to keep the assets. H has now sued the attorney for malpractice.

(2) *Civil Conspiracy*. Civil conspiracy is a tort doctrine to widen the number of defendants. Elements of a civil conspiracy include (i) an agreement between multiple persons (ii) to participate in an unlawful act or act in an unlawful manner (iii) resulting in an injury caused by an unlawful overt act by one of the parties to the agreement, (iv) which overt act was done pursuant to and in furtherance of the common scheme.

(3) *Civil Aiding and Abetting.* Contrasted from civil conspiracy, civil aiding and abetting focuses on whether a defendant knowingly gave "substantial assistance" to someone who performed wrongful conduct, not on whether the defendant agreed to join the wrongful conduct.

(4) *Limitations Common to Civil Conspiracy and Civil Aiding and Abetting in the Context of Asset Protection.* Both doctrines apply in connection with a tort action and are not grounds for liability independent of some other tort. There is considerable

doubt as to whether fraudulent conveyances are tort actions. Several cases say no. (*FDIC v. S. Prawer and Co; United States v. Franklin National Bank*). A general creditor (*i.e.*, an unsecured creditor) may not maintain a conspiracy action in some states. In the asset protection context, recovery under these doctrines may be limited to recovery from the persons who are transferees of the assets, but there is no creditor's remedy for money damages against parties who were neither transferees of the assets nor beneficiaries of the conveyance. The remedy is a recovery of transferred assets from transferees. For example, *Freeman v. First Union National Bank* (Fl. 2004) and *Warne Investments, Ltd. V. Higgins* (Ct. App. Ariz. 2008) conclude that UFTA does not provide an independent cause of action for aiding and abetting liability.

Despite the lack of success so far in extending civil conspiracy or aiding and abetting claims to UFTA actions, planners should be aware that creditors are likely to bring actions based upon theories of law outside UFTA such as creditor fraud or as a conspirator in a fraudulent transfer.

(5) *Civil RICO.* Establishing a civil liability remedy under RICO for asset protection transfers will be difficult, but liability was held to apply in *Fortney v. Kuipers* (N.D. Ill. 2001).

23. Criminal Liability Concerns

A few states, such as California and New York, have criminalized fraudulent transfers. Under federal bankruptcy law, someone who "knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation" may be fined or imprisoned up to five years. 18 U.S.C. §152(7). Several attorneys have been convicted of bankruptcy fraud for assisting clients in fraudulent asset protection actions. *E.g., United States v. Kubrick* (9th Cir. 1999); *United States v. Switzer* (2d Cir. 1958). Other federal laws also impose criminal sanctions for concealment actions to evade a tax, for concealing assets from the FDIC, and for money laundering.

24. Practical Asset Protection Strategies In Light of Ethical, Civil Liability, and Criminal Liability Concerns

The practical planning strategies suggestions are based (largely verbatim) on the presentation materials. These are strategies that should be permitted in light of the laws regarding fraudulent transfers.

a. ***Clients With Existing Mega Judgments ("Tier 1").***

Protect debtor's potential inheritance via spendthrift or discretionary trusts from third parties (e.g., wills, life insurance, IRAs).

Secure currently exempt assets such as tenants by the entirety to prevent asset enhancement upon death of non-debtor joint owner (e.g., death of non-debtor).

Transfer opportunities for future profits.

Consider spend down of assets of debtor spouse to pay family expenses, bank income from non-debtor spouse, at least for expenses relating to both spouses.

b. ***Clients Involved in Accident or Possible Negligent Action Where Exposure is Uncertain ("Tier 2")***

For example, this might include clients caught in a real estate freefall with mortgage debt.

Try to quantify exposure so clients' conveyances do not result in insolvency.

Use Tier 1 planning.

Use Tier 3 planning provided there are no fraudulent conveyances and the client remains solvent.

Consider obtaining an opinion from an attorney or appraiser (e.g., bank's appraisers) to document projected exposure.

Value real estate to determine ratios of value to debt under existing market conditions. If still solvent, consider planning.

c. ***Clients With No Existing or Contingent Claims ("Tier 3")***

Maximize homestead.

Maximize tenants by the entirety protection.

Maximize retirement assets. Create retirement plans and contribute maximum amount for income tax deferral, retirement and asset protection.

Maximize 529 plans and college pre-paid funds.

Maximize inter vivos credit shelter trusts. (Create an estate tax freeze via an inter vivos credit shelter gift and allow for discretionary distributions for spouse and possibly children. SLATs may be effective.)

Maximize inter vivos QTIP trust. (Shift assets in trust to spouse with fewer assets. Provide remainder of QTIP on death to children. The trustee controls the trust assets and invests for the spouse. Currently various states have enacted inter vivos QTIP trust legislation recognizing that if the spouse-beneficiary appoints the assets to a trust for the original donor-spouse, the donor-spouse's creditors are not able to reach the assets as a self-settled trust by the donor-spouse.)

d. ***Risk Minimization—Know Your Client.***

Source of the client's wealth.

Particulars of the client's business/employment.

Client's reasons for seeking advice and/or assistance with regard to asset protection planning.

Was the client referred by a reputable source?

Does the client have current creditor issues?

e. ***Risk Minimization—Engagement Letter***

What constitutes a fraudulent conveyance?

Consequences of making a fraudulent conveyance.

Attorney will not assist the client in making a fraudulent transfer.

Attorney relying on disclosure by client.

Breach of client's continuing disclosure constitutes grounds for the attorney to resign.

f. ***Risk Minimization—Client Questionnaire***

Any lawsuits naming the client as a party?

Has client or closely held company filed bankruptcy?

Are federal, state and local tax reportings current?

Is client being audited?

Is client aware of any pending legal action?

Does the client have any direct or indirect liability for any loan?

Has the client, or closely held company, been convicted of a crime?

g. ***Risk Minimization—Solvency Analysis***

The client should swear or affirm to the following:

No known pending or threatened claims;

No known investigations;

Not involved in any administrative proceedings;

Client will remain solvent and be able to pay debts; and

Assets are not derived from "specified unlawful activities."

See Goldberg v. Rosen (11^{th} Cir. 2012)(court found, based on Affidavit of Solvency, that debtor was solvent when the trust was created).

Items 25-35 are observations from a seminar by Erin Donovan, Steven L. Hearn and Trent S. Kiziah, Beneficiaries Behaving Badly

25. Trustee Communication and Responsiveness

a. ***Common Complaints of Trust Beneficiaries.*** The most common complaints of beneficiaries about trustees are that they haven't heard from the trust officer or that getting a decision takes too long. Common complaints include (i) the beneficiary made a request but received no response, (ii) the beneficiary made a request that was denied with little or no explanation, and (iii) the beneficiary made an inquiry but the explanation does not make sense (which seems arbitrary and unfair and therefore, also unresponsive). "Most complaints/dissatisfactions are related to a perceived lack of attention followed closely by a lack of communication."

"Beneficiaries are often unhappy because they are uninformed, misinformed, or under-informed."

b. ***Beneficiary's Perspective.*** The beneficiary often does not understand the trust document and does not understand his or her rights. The beneficiary's perspective is that the trustee "has my money, won't give me any, won't talk with me, and won't tell me my rights." The language of trust documents, terminology regarding discretionary distributions and ascertainable standards, and the concepts of balancing the rights of all beneficiaries are foreign to most individuals. From the beneficiary's perspective all of the confusion comes down to "what does this mean and what can you do for me?"

c. ***Listening.*** The trustee should consciously *listen* to the beneficiary. "Sit and listen to the beneficiary. Don't talk too much. Bite your tongue. You want the beneficiary to know you are listening."

d. ***Seating Arrangement.*** When meeting with beneficiaries, do not have the trust officers on one side of the table and the beneficiaries on the other. One speaker jokes: "It is hard to point a gun at someone sitting right next to you."

e. ***Counsel for Beneficiary.*** One speaker says that he always invites beneficiaries to bring their legal counsel to meetings, observing in jest "at least one other reasonable person will be in the room."

26. Beneficiary Requests for Information

The Uniform Trust Code addresses categories of beneficiaries who have rights and are entitled to information about the trust (although those provisions have not been "uniformly" adopted by the states that have adopted the UTC). The speakers' bias is that "more information is better." To say to someone, who is not yet a beneficiary but will be at some time, that they have no right to know what is going on with the trust immediately raises the specter in that beneficiary's mind of "hiding and malfeasance" by the trustee. "If you do encounter overly demanding, inquisitive beneficiaries, even if the statutes say it is not required, you may want to send information, give notice, and request a consensus. The risk in this is it could lead to their mistaken impression that they get a vote on future actions."

Another recurring situation is when the "black sheep" of the family repeatedly asks for information about the trust but the trust settlor does not want the trustee to release any information to that individual. Everyone should understand, however, that if the beneficiary is going to court to get information, turning over the information earlier may achieve a better long-term result.

27. Read Documents

Beneficiaries and trustees both should read the trust document. One speaker now has three pending lawsuits against trustees, all based on the trustee not reading and following explicit provisions in the trust document (including required distributions at specified ages, investments in trustee proprietary funds that were prohibited in the trust agreement, and not following specific trustee fee provisions in the agreement).

One speaker maintains that trustees should re-read trust documents annually, but in particular, every time there is a change in the trust officer. Another speaker observes that it is not realistic for corporate trustees to review every trust document every year. Federal law (Regulation 9) requires an annual review of whether trust investments are consistent with investment objectives for the trust.

Beneficiaries also have the responsibility of reading trust documents and at least understanding when distributions should be made and the standards for distributions.

28. Consideration of Outside Resources in Making Discretionary Distribution Decisions

Trust documents sometimes provide that trustees may/shall consider outside income or other resources in making discretionary distribution decisions. (The general rule in many states is that if the trust document is silent, the trustee should take into consideration outside resources.) Beneficiaries may get upset when asked to provide information about other sources of income, especially if they have not been asked for that information in the past. One speaker suggests that trust documents should be more specific than "may consider outside resources." For example, discuss particular types of distributions that might be allowable and whether outside resources should be considered for only certain types of distributions (such as vacations, elective surgery, etc.).

29. Planning Strategies to Head Off Litigious Beneficiaries

Clients are clueless about how their family members will react when money is involved. Steps that planners can take in counseling clients to head off problems with litigious beneficiaries include:

Educate clients about problems that may arise;

If the client wants to provide for his or her spouse, do not name stepchildren as trustees;

Avoid pot trusts with multiple beneficiaries if possible;

Do not use a "pot trust" with children and stepchildren having equal priorities as beneficiaries; and

Merely including stepchildren as remaindermen can create potential problems—every distribution to the surviving spouse makes the stepchildren disgruntled.

One speaker poignantly observes: "If you prepare pot trusts for beneficiaries who do not get along, you might as well have just included yourself (the attorney) as a beneficiary."

30. Beneficiary Responsibilities

Actions of responsible beneficiaries include:

Read the trust document (it is the beneficiary's responsibility to know that he or she is supposed to receive ¼ of the trust upon reaching age 30, etc.); and

Advise the trustee when the beneficiary moves or changes address, so the trustee can keep in touch with the beneficiary.

31. Settlor Discussing Trust Provisions With Beneficiaries

The settlor may be uncomfortable discussing trust provisions with beneficiaries, particularly if some of them may be disappointed with the settlor's decisions. But having the settlor educate the children before the settlor dies is very helpful. The family members can understand the trust document and reasons that the settlor picked the particular provisions in the documents. The trust officer is not viewed as the enemy enforcing "unreasonable provisions that the settlor would never have wanted to impose on me."

32. Substance Abuse Issues

If there are suspected substance abuse concerns of a beneficiary, to every extent possible make direct payments for the beneficiary's needs so that cash does not pass directly into the beneficiary's hands. In the planning context, if the client knows of an addiction problem in the family, be specific in the trust document that the trustees can use different discretionary distribution standards for particular beneficiaries or if there are substance abuse issues with a beneficiary.

33. Trustee Resignation

The trustee may be as tired of the beneficiary as the beneficiary is of the trustee. If asked, the trustee may be delighted to resign. If the trustee refuses, the trustee understands that the beneficiary may allege breach of fiduciary duties and allege a surcharge against the trustee. One speaker jokes that the trustee should "resign and give the beneficiary the name of the trust company you hate the most."

If the trustee refuses to resign, review the successor trustee provisions. The existing trustee may be more willing to resign if a responsible person or entity will become the successor trustee.

34. Attorney Conflicts of Interest

Situations may arise in which the attorney represents a disgruntled beneficiary and also represents the settlor or the trustee or another beneficiary who is receiving distributions not being made to the disgruntled beneficiary. The attorney must determine who will be the client.

Conflict situations can also arise with banks. A speaker told of a situation in which a settlor threatened to move her $30 million of assets outside the trust from the bank unless the bank-trustee agreed to take certain actions with the trust that were not appropriate. (The bank refused to take the actions and the settlor indeed removed her other $30 million from the bank.)

35. Seeking Court Guidance

The trustee may seek court guidance regarding decisions with which the beneficiaries have conflicting views. Trustees should not just seek court approval for all routine decisions, however. Non-judicial settlements may be a possible to resolve differences of opinion without the expense of court actions.

Items 36-46 are observations from a seminar by Dennis I. Belcher and George D. Karibjanian, DOMA: Dead or Alive?

36. General Background Regarding DOMA and Same-Sex Marriage

a. ***Defense of Marriage Act.*** The Defense of Marriage Act ("DOMA") was passed in 1996. For the purpose of over 1,000 federal laws and numerous federal regulations, Section 3 of DOMA defines "marriage" as the legal union between one man and one woman as husband and wife, and the word "spouse" as a person of the opposite sex who is a husband or a wife. Section 3 of DOMA prevented same-sex married couples from being recognized for purposes of government employee benefits, Social Security benefits, tax benefits and filing status, and other aspects of federal law.

b. ***State Laws.*** Fourteen states and the District of Columbia recognize same-sex marriages. (California, Connecticut, Delaware, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New Jersey, New York, Rhode Island, Vermont, and Washington.) (A New Jersey statute bans same-sex marriage but a recent trial court case, *Garden State Equality v. Dow*, held the statutory ban to be unconstitutional in light of *Windsor*, and Governor Christie withdrew his administration's initial decision to appeal the case.) The Illinois legislature has passed a same-sex marriage provision, expected to be signed by the Governor and become effective sometime in the summer of 2014. These fourteen states and the District of Columbia that now recognize same-sex marriages represent about 33% of the population of the U.S.; the addition of Illinois will take that percentage to well over 1/3 of the U.S. population. Eight states recognize civil unions or domestic partnerships (California, Colorado, Hawaii, Nevada, New Jersey, Oregon, Wisconsin, and Illinois). Thirty-five states specifically ban same-sex marriage, either by statute or constitutional amendment (although some of them recognize civil unions or domestic partnerships).

37. Windsor v. United States

In this estate tax refund case, based on whether bequests to the same-sex surviving spouse qualified for the estate tax marital deduction, a five-member majority of the Supreme Court, under an opinion by Justice Kennedy, affirmed the Second Circuit decision and declared Section 3 of DOMA to be unconstitutional. The Court was split on conservative/liberal lines. The reasoning was basically that Section 3 of DOMA violates basic due process and equal protection principles under the Fifth Amendment, without much more analysis than that. Justice Scalia's dissent chided the majority for its brief, summary analysis.

38. Constitutionality of State Law Restrictions on Recognition of Same-Sex Marriage

In *Windsor*, the Supreme Court did not address Section 2 of DOMA, which allows states to refuse to recognize same-sex marriages performed under the laws of other states. Section 2 of DOMA provides that "No state … shall be required to give effect to any public act, record, or judicial proceeding of any other State … respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other States … arising from such relationship."

In *Hollingsworth, et al. v. Perry et al.*, 133 S. Ct. 2652 (2013), the Supreme Court let stand lower court decisions holding that California's Proposition 8 (which said that only a marriage between a man and a woman would be valid in California) was unconstitutional. The 9th Circuit opinion applied narrow reasoning that applied to only the California statute. (The Supreme Court did not reach the merits of the constitutional issue but held that the individual citizens who brought the case did not have standing to pursue the case because they had not been aggrieved.)

The briefs in *Perry* addressed wide ranging constitutional issues, including the Fourteenth Amendment. Those constitutional arguments are being considered in a number of cases now pending throughout the country involving state recognition of same-sex marriages.

The *Windsor* case dealt with the recognition of same-sex marriages for federal law purposes, and a case regarding the constitutionality of state law limitations on the recognition of same-sex marriages will likely appear before the Supreme Court at some point. Some pundits anticipate that this will happen within the next 4-5 years.

39. Revenue Ruling 2013-17

Rev. Rul. 2013-17 has three holdings and a clarification regarding its prospective application. (1) For federal tax purposes, terms relating to marriage included same-sex marriages. (2) A "place of celebration" standard is used for determining if same-sex couples are married (i.e., the marriage is recognized as long as the jurisdiction where the marriage was performed recognizes the marriage). (3) Domestic partnerships and civil unions are not treated as marriages for these federal tax law purposes. (4) The Ruling is applicable as of September 16, 2013, but refund claims may (but need not) be filed for prior years as long as the statute of limitations on the refund action is still open. (Perhaps this last position was pragmatic; the IRS did not want to have to deal with thousands, or tens of thousands, of PLR requests about obtaining refunds.)

Further guidance will be coming from the Treasury regarding the application of *Windsor.* It focused on the issues covered in Rev. Rul. 2013-17 to assist individuals who needed to file income tax returns (or refund claims) by the extended filing deadline of October 15, 2013.

40. Refunds for Prior Years; "Closed Years"

If an amended return or claim for refund is filed, the couple will be treated as married for all purposes on that "return or claim"; for example, the attribution rules under §267 might apply. Nothing indicates that the couple must be treated as married for all federal tax purposes during that prior year; for example, a couple may be able to file a claim for refund of gift taxes for a prior year to claim the marital deduction without having to treat the couple as being married for income tax purposes during that same year.

In the gift tax context, if a donor paid gift tax in prior years for which the statute of limitations has closed on obtaining a refund, even though the IRS will not allow a refund, will the individual's use of unified credit be restored for purposes of subsequent gifts or for estate tax purposes at the individual's death?

Taxpayers will likely challenge the inability to obtain a refund for closed tax years based on the theory that the finding that DOMA was unconstitutional means that it was *void ab initio*. However, the Service would likely win that argument because the ability to file a protective claim for refund provided an adequate remedy. The Supreme Court in *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco, Dept. of Business* (1990), addressed the constitutionality of not allowing refunds for prior payments of a state tax that was held to be unconstitutional under the Commerce Clause. That case suggests that refunds will not have to be given for closed years:

"And in the future, States may avail themselves of a variety of procedural protections against any disruptive effects of a tax scheme's invalidation, such as providing by statute that refunds will be available to only those taxpayers paying under protest, *or enforcing relatively short statutes of limitation applicable to refund actions* … Such procedural measures would sufficiently protect States' fiscal security when weighted against their obligation to provide meaningful relief for their unconstitutional taxation." (emphasis added)

A speaker suggests that the remoteness of a statute's unconstitutionality should be considered as a factor to reopen the statute of limitations. In this situation, *no one* had any idea four years ago that DOMA would be overturned on constitutional grounds by 2013 or that there was any reason to file protective refund claims. That would have been viewed in some legal circles as merely churning of unnecessary legal work.

There may be relatively few "closed year" issues that will arise because Massachusetts was the only state that recognized same-sex marriages until 2008.

41. Employee Benefits

The IRS made clear in Rev. Rul. 2013-17 that it will issue further guidance on the retroactive application of *Windsor* "to other employee benefits and employee benefit plans and arrangements. Such guidance will take into account the potential consequences of retroactive application to all taxpayers involved, including the plan sponsor, the plan or arrangement, employers, affected employees and beneficiaries." As suggested by the broad range of affected taxpayers, there are many complexities in applying *Windsor* retroactively to employee benefit plans. For example, what if the participant's same-sex spouse did not sign a spousal waiver, the participant died, and the plan did not pay the required joint and survivor annuity to the survivor? Or what if a participant has died and the same-sex spouse did not elect rollover treatment and has received some distributions without taking advantage of the special rules for surviving spouses under the minimum distribution rules? (The spouse could still elect rollover treatment as to amounts still in the plan or IRA but likely would not be able to "undo" the actual distributions that have been paid.)

42. Tax Advantages for Same-Sex Spouses

The IRS position may result in a wide variety of potential advantages for same-sex spouses including in areas such as: estate and gift tax marital deduction; portability; disclaimers; gift-splitting; joint income tax returns (although for many this will be a disadvantage due to the "marriage penalty"); non-recognition of gain for interspousal transfers; S corporation shareholder rules; grantor trusts (indeed, the grantor trust status of previously created irrevocable trusts may have changed as a result of the marriage being recognized); jointly owned property rules under §2040(b); marriage settlement agreements; availability of basis step-up for all community property at the first spouse's death under §1014(b)(6); and generation-skipping planning.

43. Tax Disadvantages for Same-Sex Spouses

For a variety of other purposes, treating same-sex couples as being married for tax purposes may be disadvantageous in various respects, including the following areas: income tax "marriage penalty" if both spouses have significant income; mortgage interest deduction; deductibility of losses; Chapter 14 limitations that apply to spouses; private foundation disqualified person rules; stock attribution rules; and state income taxes (as discussed below).

44. State Tax Effects

A huge uncertainty is how *Windsor* will affect state income taxes. There are 24 states that do not recognize same-sex marriages but require taxpayers to refer to the federal gross incomes in calculating state income taxes. For married individuals, the federal gross income is the combined income on the spouses' joint federal income tax return. It appears that many states are requiring the same-sex couple—whose marriage is now recognized for federal income tax purposes but will not be recognized in those states for state income tax purposes—to prepare "dummy" federal returns for two single taxpayers. Oregon released a directive taking this position on October 18, 2013:

"Such individuals who file a federal income tax return as married filing jointly or married filing separately must each complete a separate pro forma federal return for North Carolina purposes with the filing status of single or, if qualified, head of household or a qualifying widow(er) to determine each individual's proper adjusted gross income, deductions and tax credits allowed under the Code of the filing status used for North Carolina purposes, and then attach a copy of the pro forma federal return to the North Carolina return."

This same issue may arise for state estate tax purposes. Four of the states with a state estate tax do not recognize same-sex couples. In those states, will a dummy federal estate tax return (prepared as if the marriage was not recognized for federal tax purposes) be required to be filed with the state estate tax return?

45. Divorce Effects

If the couple lives in a state that does not recognize the validity of the same-sex marriage performed in another state, the state of domicile may not recognize that it has any jurisdiction to grant a divorce (oral arguments were recently heard on a pending case in the Texas Supreme Court involving that issue) and the parties may be unable to obtain a divorce in the state in which they were married if they have not both lived in that state for a specified period of time. Some jurisdictions have overcome this barrier. For example, effective August 16, 2013, non-resident spouses married in Canada may obtain a divorce in the province where their marriage was performed if (a) the spouses have lived separate and apart for at least one year, (b) neither spouse resides in Canada when applying for divorce, and (c) both spouses reside, and have resided for at least one year immediately preceding the application, in a state that will not grant them a divorce because that state does not recognize their marriage. Delaware, the District of Columbia and Vermont allow divorce without a residency requirement of same-sex spouses married in those jurisdictions if the couple lives in a state that will not dissolve their union (Vermont has several other requirements as well). For a good resource of current law on the availability of divorce for same-sex couples who live in non-recognition states, see the National Center for Lesbian Rights website.

46. Fiduciary and Trust Construction Issues

Whether same-sex marriages are recognized for state law purposes may have an impact in construing trust provisions. For example consider the following.

A trust is for the benefit of child for life, at which time it passes to the child's spouse. If the same-sex spouse is not recognized, the trust would not pass to that spouse.

A trust beneficiary's spouse is a permissible appointee under a power of appointment. If the same-sex spouse is not recognized, the spouse would not be a permissible appointee.

A trust passes to the settlor's daughter's issue at the daughter's death. What if the daughter cannot conceive but her same-sex wife can conceive and delivers a child. Perhaps the daughter lives in a state that recognizes the marriage and has a state law providing that if married a child of either spouse is deemed to be the child of both. However, the trust instrument says it is governed by Florida law and Florida does not recognize the marriage. Is that child considered a child of the daughter? (If the daughter adopts the child, the child would be recognized as the daughter's child.)

Many of these trust construction issues could be clarified in drafting the trust. For example, the trust agreement in the prior example could provide that issue of the daughter's same-sex spouse either will or will not be considered as the daughter's issue for purposes of the trust distribution provisions regardless what state law provides. The only limitation to being able to draft around potential uncertainties is whether the provision would be rejected on public policy grounds. (George Will points out that the number of people who are opposed to recognizing same-sex marriages is getting smaller and smaller as older people die off. What once was contrary to public policy may no longer be contrary to public policy in the future.)

Other state law rights may be impacted by whether the state recognizes a same-sex marriage.

Elective Shares. There is no elective share if the state does not recognize the marriage. A domestic partnership agreement may be necessary to provide some kind of "inheritance rights" if that is desired by the same-sex married couple who lives in a state that does not recognize the marriage.

Community Property. Community property only exists between spouses, and presumably there could be no community property if the state does not recognize the same-sex marriage.

Fiduciary Appointments. If a same-sex spouse is not named as a fiduciary, the spouse would lose any preference that spouses have under state law in being appointed as a fiduciary if the state does not recognize the same-sex marriage.