BESSEMER TRUST

ACTEC 2015 Summer Meeting Musings

June 2015

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This summary reflects the individual observations of Steve Akers from the seminars at the 2015 Summer Meeting and does not purport to represent the views of ACTEC as to any particular issues.

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Important Information Regarding This Summary
This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Introduction

Some of my observations from the 2015 ACTEC Summer Meeting Seminars in Quebec City, Quebec, Canada on June 17-20, 2015 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 1-48 come from the "Stand Alone" program titled "The Migrating Client." Items 49-63 come from a seminar titled—"What Your Clients Really Care About: Planning For and Dealing With Treasured Art and Collectibles."

Items 1-4 are observations from a session by Trent Kiziah—A Statistical Analysis of Inter-State Migration Patterns in America

1. General Migration Flows Within the United States

a. **Total Moves.** Forty-five million Americans moved in 2013, representing 15% of the population. Sixteen percent of those (or 7 million) moved to another state. Over 10 years, 70 million people will move between states. Six percent of the movers were over age 65, representing 4.5 million people over 10 years. About 59% of people still live in the same state in which they were born.

b. **Top Particular State-to-State Moves.** The top number of moves between particular states are as follows (in order): New York to Florida, California to Texas, California to Arizona, Florida to Georgia, New Jersey to New York, New York to New Jersey, California to Nevada, Georgia to Florida, California to Washington, and Texas to California.

c. **Top Moves to Particular States.** The top states in terms of total moves into the state (domestic and international) are, in order: Texas, Florida, California, Arizona, Virginia, North Carolina, Colorado, Washington, Georgia, and South Carolina.

d. **Ages of Movers.** After persons reach age 44, moves across state lines are less common. The percent of residents born in the state in which they reside is about 50% for those between ages 25 and 44, and that percentage drops very little for older age groups.

e. **Wealth.** Wealthier people tend to move between states more than poorer people.

f. **Top Retirement Cities.** The top ten retirement cities, in order, are Phoenix, Tampa, Atlanta, Las Vegas, New York, Washington, D.C., Dallas, Chicago, Fort Myers, and Orlando.

2. Immigrant Population

a. **Variation in Population Percentage.** From 1850 to 1930, immigrants composed about 10-14% of the population. The percentage of immigrants dipped gradually to

about 5% in 1970, and has gradually risen since, reaching about 13% in 2013-back to the level in 1860.

b. **Top States Attracting Immigrants.** The top states in terms of the numbers of immigrants are, in order: California, Texas, Florida, New York, Illinois, Pennsylvania, Virginia, Massachusetts, New Jersey, and Georgia.

3. Congressional Seat Changes Upcoming

Congressional seats in the U.S. House of Representatives are allocated on the basis of state populations, determined by the census taken at the beginning of each decade. Changes in the number of Congressional seats allocated to states reflect migration patterns.

If current population trends continue, Texas will gain 3 Congressional seats after the 2020 census, and the following states will gain one Congressional seat: Arizona, California, Colorado, Florida, North Carolina, and Oregon. The following states will each lose one Congressional seat: Alabama, Illinois, Michigan, Minnesota, New York, Ohio, Pennsylvania, Rhode Island, and West Virginia.

4. Majority-Minority States

Minority ethnic groups constitute a majority of the population in the following states: Hawaii (79%), New Mexico (61%), California (60%), and Texas (56%). Additional states expected to become majority-minority states over the next thirteen years are: Nevada (2019), Maryland (2020), Arizona (2023), Georgia (2025), Florida (2028), and New Jersey (2028).

Items 5- 12 are observations from a session by T. Randall Grove and Jerome L. Wolf—The Basics of Residency, Domicile and Key Factors

5. Significance of Domicile and Residency

Domicile and residence are very important for purposes of determining what state can collect income tax from an individual. Other issues that depend on the state in which a person is domiciled include: state transfer taxes, exemption from ad valorem tax (for example, in Florida, only persons domiciled in Florida are entitled to the homestead exemption from the ad valorem tax), exemptions from creditors' claims and rights of creditors against the individual, who inherits from an individual, who may administer an estate, and who may make medical and "pull the plug" decisions for the individual.

Domicile is also important for bankruptcy purposes. Section 522(b) of the Bankruptcy Code allows a debtor to choose between the federal exemptions listed in §522(d) unless the state dictates that its domiciliaries may only use the state exemptions.

6. Domicile Definition

a. **Domicile of Origin.** A person's domicile of origin is the permanent residence of the person's parents.

b. **Domicile by Operation of Law.** In certain situations, an individual may be deemed by operation of law to be domiciled in a particular place (for example, domicile arising from marriage).

c. **Domicile of Choice**. The domicile of choice is the permanent place a person has chosen as the place to which he or she intends to return, and which displaces his or her previous domicile. This is the most important type of domicile. The domicile of choice requires *intent* and *abandoning* the prior domicile. These are questions of both fact and intention. Actions, not words control; has the person actually moved and terminated contacts with his or her former state?

d. **Time.** There is no magic time that a person must live in another state to change the domicile.

e. **Motivation.** The person's motivation for changing domicile does not matter. An individual can change domicile to achieve tax benefits as long as the person can establish that he or she moved with the intent of making a new home.

f. **Proof**. The burden of proof is on the person asserting a change in domicile by clear and convincing evidence.

g. **Multiple States May Assert Domicile**. The U.S. Supreme Court has ruled that a person's domicile is, in many cases, for the states to decide, and that it is not unconstitutional for more than one state to claim a decedent as a domiciliary of that state for state estate tax purposes. *Texas v. Florida*, 306 U.S. 398, 430-32 n.4 (1939).

7. Factors In Determing Domicile

a. **Primary Factors**. The New York Department of Revenue identifies factors determining domicile into two categories, primary and secondary factors. Primary factors include: (1) House (local residence compared to residences in other states, size and value of each, and the nature of the use of each residence); (2) Active business involvement; (3) Time the individual spends in the state; (4) Where "near and dear" items or items with significant sentimental value are located; and (5) Family connections (where children attend school and the frequency of visits with children and grandchildren).

b. **Secondary Factors.** There is a long list of secondary factors that are considered, but these are only secondary to the primary factors. These include involvement in charitable organizations, membership in religious organizations, address at which banking statements and bills are received, safe deposit box location, vehicle registrations, driver's license location, voter registration, frequency of business and employment activities in the state, telephone services, and location of important legal documents.

c. **Nonfactors**. Nonfactors include (but are not limited to): interment location, where the person's will is probated, passive interests in partnerships or corporations, bank account location, contributions to political causes, where the individual income returns are prepared and filed, and charitable contributions.

8. Statutory Residence

The ability of a state to tax the income of an individual is often based on the person either being domiciled in the state or having a "residence" (as defined in the state taxing statutes) in the state. The statutory definitions of residence vary among the states.

In New York, a statutory resident is an individual who (i) maintains a permanent place of abode in New York (meaning a house, apartment or coop or other dwelling suitable for year-round use which has been held at least 11 months during the year) and (ii) spends in the aggregate more than 183 days of the taxable year in the state, unless (iii) the individual is in the U.S. armed forces.

9. Temporary or Transitory Residence

Some states apply a temporary or transitory test. An individual (even if not domiciled in the state) who is in the state for other than a temporary or transitory purpose is treated as a resident of the state. (For example, how long can a "snowbird" stay in California during the winter and not be a resident of California?) Conversely, if an individual who is domiciled in the state and is outside the state for only a temporary or transitory purpose, the person is still considered a resident of the state. A number of Western states apply this (or a similar) approach, including California, Arizona, Washington, and Oregon, as well as Illinois in the Midwest.

The key of whether a person's presence is temporary or transitory is whether a reasonably short and definite time limit or a specific assignment or transaction exists. Any type of activity (including health, vacation, business, employment, investment) may constitute a temporary or transitory purpose. ("Are there 'book ends' around the time in the state?") Making the temporary or transitory decision may be difficult if a person spends significant time and engages in significant activities in multiple states. A "closest connection" test applies (social, personal, and financial activities).

Certain presumptions may be applied. For example, in California, a person is presumed to be a resident who is in the state for 9 months unless he or she is there for a temporary or transitory purpose, and a person is presumed to be a non-resident if in the state for 6 months or less and engages only in the activities of a tourist (California does not want to discourage winter guests). In Oregon, a 200-day statutory residence test applies unless the person is in the state for a temporary or transitory purpose.

10. Planning Ideas

Various steps may be taken to minimize contacts with a state to avoid being treated as a resident (and subject to income taxes) in that state. These include: (i) Structuring accounts, investments and employment so income tax returns do not have to be filed in the state; (ii), Avoiding opening accounts that originate in that state (perhaps other than a

"bill paying" account); (iii) Avoiding using an address in that state as the primary address for any purpose (other than related to the vacation or other temporary residence in the state); (iv) Documenting the amount of time spent in the state with a log and receipts; and (v) Telling friends about intent and actions so that affidavits of others can be prepared, if needed.

11. Military Service

The Federal Servicemembers Civil Relief Act ("SCRA") provides that a person's residence and domicile is not lost or changed due to compliance with military orders. Compensation from military service is not considered to be from services within the state if the state is not the serviceperson's domicile. While in the military, a duty station is considered a permanent place of abode.

12. Example of Interaction of Domicile, Statutory Residence, and Temporary or Transitory Residence

Assume that a senior adult with diminished capacity changes residence (to Oregon) to live with or near her children. If the person is in Oregon more than 200 days, she will be considered an Oregon statutory resident even if she is not cognizant of the move—unless it is temporary or transitory. But if the person has Alzheimer's disease with no hope of getting better, the person would not likely satisfy the temporary or transitory test, so the person would be a resident of Oregon for income tax purposes.

For estate tax purposes, however, the required nexus to a state is based solely on domicile, not residency. The person did not make a conscious decision to abandon her home and acquire a new domicile. If the prior state does not have an estate tax, be careful not to change the person's domicile. Document that she is not making the decision to move, that she is not aware of the move, and that her doctor and children are making the decision to move her.

Items 13-26 are observations from a session by Stephen R. Akers and Katarinna McBride—Domestic Non-Tax Issues

13. Overview of Domestic Non-Tax Issues for Migrating Clients

A client's estate plan is not automatically devastated when the client moves to a different state. The client's will is almost certainly still valid (because the formal will execution requirements are fairly uniform throughout the U.S. and because of Uniform Probate Code (UPC) §2-506 (and similar statutes adopted in non-UPC states). Property laws throughout the U.S. are much more uniform than for clients moving between countries in Europe. But an audit of the client's estate planning situation is well advised. Important distinctions among the states can have significant effects on the estate plan. Some of the more important issues for which there can be significant distinctions include:

- Community property (particularly moves from a non-community property state to a community property state, or vice versa);

- Spousal rights in non-community property states;
- Ownership of property, particular co-ownership issues;
- Rule against perpetuities; and
- Creditors' rights (addressed in more detail in a separate session, summarized below).

The client's attorney will also be faced with the issue of whether to continue representing the client after the move to a different state.

Items 14-17 below address community property issues.

14. What is Community Property?

a. **Community.** In order to have community property, a "community" must exist (typically a marriage). Same-sex couples can have community property. 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.

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 and Partition.** In most community property states, spouses may agree to treat property as community property that would otherwise be separate property. Conversely, spouses may "partition" community property into the separate property of the spouses.

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 the Uniform Marital Property Act that does not have the same Spanish law background but is a community property system. It is a mandatory regime unless the couple opts out of it. (The IRS has recognized that Wisconsin marital property is the equivalent of community property for federal income tax purposes. Rev. Rul. 87-13, 1987-1 C.B. 20.)

Alaska has adopted the Uniform Marital Property Act on an elective basis (i.e., spouses can opt-in to the community property system, *see* ALASKA STAT. § 34.77.060(a)). 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.) In Louisiana, the spouses can opt-out of community property before they are married or within one year of when they move to Louisiana.

Most non-English speaking civil law countries have marital property systems much like community property. For example, China has a 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 "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."

15. 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 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. Generally, though, for debts incurred either before or during the marriage, creditors of either spouse may be able to reach the community property assets, and a spouse's separate property may not be reached by creditors of the other spouse.

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.

16. 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. *See* Restatement (Second) of Conflicts of Law §234. 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 that is 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 where the 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. States generally *classify and divide* all property under the law of the forum. Some states (a minority) *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 (i.e., the decedent can dispose of one-half of the quasi-community property), 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.

Some planners view this as a substantial potential problem for migrating clients. As an example, David Estes (Scottsdale, Arizona) describes how this plays out in representing new clients who have migrated to Arizona from a non-community property state:

> "As a result of this problem (which has existed as long as I have been practicing), when Arizona estate planners meet with these migrating clients, one of the first things we get to discuss with the clients is this problem. We are often left having to point out to the couple (whom we have just met!) that, unless the 'propertied' spouse is willing to convert (more or less immediately) a substantial part of his/her separate property (that would be treated as 'quasi-community property' for divorce purposes) into community property, the 'non-propertied' spouse is at risk of being disinherited and might be much better off filing for divorce rather than waiting to see how his/her spouse's estate plan turns out. (You can imagine how that conversation inspires trust and confidence between the estate planner and the couple.)"

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. See Item 21 below.)

17. Planning Strategies for Migrating Clients Involving Community Property States

The following planning strategies are based on a seminar given by Kenneth W. Kingma and Read E. Moore at the ACTEC 2013 Fall Meeting.

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 "three-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 or Undesirable.**

   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 healthier 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.

Creditors' Rights. As discussed in Item 15.b above and Item 27 below, having property held as community property rather than separate property of one spouse may subject more of the marital property to creditors' claims. Community property may generally be reached to satisfy the debts of either spouse.

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 if they want to preserve the community property character of the assets. 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.

18. The Six "D's"

Katarinna McBride points out that four big "D's" that can impact a client's estate plan are **D**eath, **D**ivorce, **D**isability, and **D**isinheritance (really taking steps to avoid disinheritance). Another important "D" is **D**omicile—critically important for migrating clients. Jack Terrill pointed out yet another "D" critical to estate planning—**D**ebt (i.e., building creditor protection).

19. Will Validity

A will is not invalidated by a testator's move to a different state (or for that matter, in many situations to a different country). The formal will execution requirements are similar throughout the U.S. Even if one of the formal execution requirements is not satisfied, the situation may be salvaged by UPC §2-506, stating that a will that is validly executed in the state where it was signed or in the state of the person's abode or nationality is generally recognized in other states. Some states that do not have the UPC have similar legislation (*e.g.,*TEX. EST. CODE §251.053 (effective Sept. 1, 2015)).

20. Self-Proving Affidavit

Most, but not all, states allow "self-proving" wills. (The District of Columbia, Maryland, Ohio and Vermont do not have self-proved wills.) Some states (such as California, Indiana, and New Hampshire) do not require a separate self-proving affidavit for witnesses to sign in order for the will to be treated as "self-proving." If a client executes a will in a state that does not have self-proving wills, re-executing the will with a self-proving affidavit may avoid problems in "proving up" the will at the client's death. Some attorneys have reported that courts have required them to offer formal proof of the will execution if the will was executed in a state that did not have a separate self-proving affidavit attached to the will.

California requires that the words "under the laws of the State of California" be included in the will's attestation clause in order for the will to be treated as self-proved.

21. Spousal Rights in Non-Community Property States

Most non-community property states afford certain rights to spouses, typically called "elective share" rights but sometimes referred to as dower or curtesy. The elective share rights varying substantially among states, and a migrating spouse may significantly increase or decrease his or her guaranteed spousal rights as a result of the move, depending on the laws of the respective states.

Some of the variances among state laws regarding the elective share are the following.

(1) What is the size or percentage of the elective share (which may depend on whether there are children born to a marriage, or children born to a separate marriage)?

(2) Can the elective share be defeated by revocable trusts or will substitutes or by lifetime transfers, or can a QTIP trust be used to satisfy the elective share?

(3) Is the length of the marriage a consideration?

(4) Do augmented estate rules apply to limit disinheriting a spouse through non-probate or pre-death transfers?

(5) In Florida, an elective share trust can be prepared to meet the elective share requirements.

(6) Can the elective share right be waived in a marital property agreement? How will an out-of-state marital property agreement be interpreted?

For a summary of the elective share laws in the respective states, see ACTEC Study 10, *Surviving Spouse's Rights to Share in Deceased Spouse's Estate* (compiled by Robert Joslyn and updated through August 2004). For an outstanding discussion of planning strategies regarding the elective share, see Jeffrey N. Pennell, *Minimizing the Surviving Spouse's Elective Share* (2006).

22. Health Care Powers, Powers of Attorney, Marital Property Agreements

a. **Health Care Powers and Powers of Attorney.** When an individual moves to a new state, updating powers of attorney, living wills, and health care proxies to conform to the forms generally recognized in the new state is a good idea. One of the biggest problems of using such documents is not their actual legal validity, but whether third parties will recognize them. Banks and hospitals may be reluctant to rely on another state's forms. Having fairly recently executed documents in a familiar format in the state can be very helpful, as a practical matter, in convincing third parties to rely on the documents. The appointment of health care representatives varies significantly from state to state.

   In addition, there can be substantive law differences; for example, some states may not accept the plenary powers in financial powers of attorney unless they are delineated in the way required by that particular state. For example in Florida, the estate planning powers must be specifically described for the provision to be effective, beyond just authorizing a general power to create or modify an estate plan (with detailed powers, such as "My agent may create and fund a revocable trust on my behalf.")

   A client with touch points in multiple states may wish to have a set of powers for each state.

b. **Marital Property Agreements.** There is wide disparity among the states regarding the requirements for a valid marital property agreement. Many states, including those that have adopted the Uniform Premarital and Marital Agreements Act, recognize voluntary informed agreements of spouses, while other states take a more restrictive approach. Accordingly, determining which state's law applies regarding the marital

agreement (and in particular, whether the state where the agreement is to be enforced will defer to the law that applied where the agreement was entered into) is critical.

Among the variations in the laws of the states that can be quite important:

Is the agreement subject to a "fairness" standard or an "unconscionability" standard?

When is the "fairness" tested—when the agreement was entered into, when it is to be enforced, or at both times?

What financial disclosure is required and can it be waived?

Are post-marital agreements recognized (most states recognize pre-marital agreements but some states do not recognize post-marital agreements)?

Will a state that does not recognize post-marital agreements allow modifications to a pre-marital agreement in order to address concerns raised by the move to a new state?

23. Rule Against Perpetuities

Consider revising the estate planning documents to be consistent with the rule against perpetuities in the state to which the clients have moved. There is some concern, under conflicts of law principles, whether incorporating the perpetuities laws of another state will be recognized. If the clients move to a state with a longer perpetuities period than the prior state where the estate planning documents were prepared, the family may not be able to take advantage of the longer perpetuities period in the new state if the documents have perpetuities savings clauses based on the rule in the prior state.

24. Ownership of Assets

The manner in which parties own property is especially important if there are co-owners. A married couple may co-own property in at least five different ways: (i) tenancy in common, (ii) joint tenancy or joint tenancy with right of survivorship, (iii) tenancy by the entireties, (iv) community property, or (v) community property with right of survivorship. There are differences among the states as to how property may be co-owned in these various manners. For example, some community property states have special rules that must be followed in order to hold community property with a right of survivorship.

The states vary significantly with respect to the manner and extent to which spouses can hold property in a tenancy by the entireties. This form of ownership typically requires that both spouses must join in any conveyance of any interest in tenancy by the entireties property, including involuntary conveyances. This means generally that creditors cannot reach the property except for the creditors of both spouses. As an example, spouses residing outside of Florida apparently can purchase Florida real estate and title it as tenants by the entireties and the Florida residence will be protected even if there is a bankruptcy filing in a different state. However, tenancy by the entireties property held in a joint revocable trust will lose its creditor protection if a judgment is obtained against just

one spouse. See Item 28 for a further discussion of the creditor protection aspects of tenancy by the entireties.

Some states do not provide for tenancy by the entireties, so clients should consult local counsel to determine how they should hold title to their primary residences. Other states allow couples to hold multiple parcels as tenants by the entireties, even if one spouse is not domiciled in that state.

In California, transferring ownership of real property may trigger re-assessment of the property for ad valorem property tax purposes. The California property tax is a hefty tax and planning to avoid a reassessment of property tax value is a substantial factor in estate planning decisions in California. Under Proposition 13 (which was passed in 1978), the maximum amount of property tax on real estate that can be charged by counties is limited to 1% of the assessed value and the assessed value of the property cannot increase more than 2% per year. The base year value (which could go back to 1975) can be reassessed in cases of (a) a change in ownership, or (b) completion of new construction. For real estate that has been owned for several decades (even back to 1975), the increase in assessed value on a change of ownership can be quite substantial—with an *annual* additional property tax thereafter of 1% of that substantial increase in assessed value. There are other exemptions as well; under the homestead program, homeowners who live in their homes as their principal residence qualify for a $7,000 reduction in the taxable value of their property. Planning often revolves around making optimal use of exemptions from property reassessment, including transfers to spouses or up to $1.0 million for transfers from a parent to a child.

25. Continued Representation of Client in the New State

The client may want the long-time attorney to continue representing the client even after the client moves to the new state. Even assuming the attorney can get beyond "unauthorized practice of law" issues (see Items 44-48 below), the attorney may want the assistance of local counsel in the new state. (Reviewing existing estate planning documents for local law issues can be problematic. Despite limitations on the scope of the engagement in the engagement letter, questions may be raised regarding the extent to which the attorney in the new state is responsible for other potential snares in the existing documents.)

Another speaker somewhat jokingly said that upon a request to continue advising a client who has moved to another state, the reaction might be: for a client with under $10 million-"good luck;" for a client with $10-$50 million- "I'll help you find someone;" and for a client with over $50 million- "I'm happy to continue to do your work and I'll hire a "caddy" in your new state to assist me.")

26. Divorce Concerns for Beneficiaries

The mobility of clients' children must also be considered in connection with how "divorce-proof" estate plans can be for the beneficiaries. The laws of another state (i.e., the state where a beneficiary lives at the time of a divorce) may govern with respect to state property rights. Forum shopping may be important. In preparing trusts, realize that attorneys cannot give absolutes regarding how protective a trust will be at a beneficiary's

divorce—because that depends on where the beneficiaries may be living. Colorado has case law saying that appreciation in trust assets is marital property. Massachusetts considers the interests that one spouse may have in trusts in making an equitable distribution of marital assets.

Items 27-32 are observations from a session by John A. Terrill, II, Debtor and Creditor Issues: How Choice of Domicile May Affect a Client's Exposure to Creditor Claims

27. Overview of Creditors' Rights Impact on Migrating Clients

Creditors' rights issues are very local law-centric. The rights of creditors in a new state may be significantly different than in the old state for a migrating client. About half the U.S. population lives in states with significant creditor protection laws. For example, Pennsylvania, Delaware, Nevada and Florida have fabulous protection. In contrast, New Jersey does not afford strong protection against claims of creditors.

The aspect of client migration brings in a new element in the general approaches to asset protection planning. One approach has been referred to as an "exporting the assets" approach, another as the "importing the law" approach, and the additional component of a migrating client raises the aspect of an "export the client" approach.

Converting separate property to community property, if spouses move to a community property state, may subject more of the marital property to creditors' claims. Community property generally may be reached to satisfy the debts of either spouse.

28. Tenancy by the Entireties

a. **Overview.** About half of the states recognize tenancy by the entireties ownership of property between spouses. The spouses each own an undivided one-half interest in the whole and have a present right to use the property. The spouses have survivorship rights in the property (i.e., the surviving spouse owns all of the property). Property held as tenants by the entireties generally may not be reached by a creditor of only one of the spouses. Joint creditors of both spouses can enforce payment out of assets held as entireties property.

b. **State Variances**. While half of the states recognize tenancies by the entireties, there are substantial variances in those provisions.

   - In some states, creditors cannot reach or impose any restrictions on the entireties property at all (Pennsylvania, Delaware, North Carolina, Virginia, and Florida).
   - Some jurisdictions (for example, New Jersey) allow the creditor of one spouse to place a lien against the debtor spouse's interest in the property, which is subject to the surviving spouse's survivorship interest; the non-debtor spouse may retain possession of the property and if the non-debtor spouse survives, the lien is extinguished.

- Nine states limit tenancies by the entireties to real property (for example, New York only permits real property and, in some cases, shares of stock of a cooperative apartment corporation).
- A few states (e.g., Illinois and Massachusetts) further limit recognition to only the couple's principal residence.
- In most (but not all) jurisdictions with broader protection, real and personal property titled in the couple's joint names may be presumed to be held as a tenancy by the entireties.
- For summaries of state laws regarding tenancies by the entireties, see ACTEC State Survey, Tenancy by the Entireties (prepared by Barry A. Nelson, updated through May 2012) and ACTEC State Survey, Tenancy by the Entirety States and Qualified Spousal Trusts (prepared by Robert K. Kirkland, updated through January 2014).

c. **Conflicts of Laws Principles.** Under general conflicts of laws principles, moveable property acquired by a couple when they are domiciled in a state that recognizes tenancies by the entireties in personal property may continue to enjoy creditor protection against the separate creditors of either spouse even after the couple moves to a state that does not recognize tenancy by the entireties.

d. **Outstanding Resource.** For a detailed discussion of the creditor planning impacts of tenancy by the entireties property, see Fred Frank, *Asset Protection and Tenancy by the Entirety*, 34 ACTEC L.J. 210 (2009).

29. State Statutory Exemptions

All states recognize certain assets that are exempt from creditors' claims, and those state exemptions vary widely. Some of the most important categories of exempt assets are life insurance (based on the domicile of the insured), annuities, IRAs, and inherited IRAs. Some states also exempt wages, salaries and commissions of individuals while in the hands of the employer.

Inherited IRAs. *Clark v. Rameker*, 134 S. Ct. 2242 (2014) clarifies that inherited IRAs are not "retirement funds" for purposes of the federal exemptions under the Bankruptcy Act, but debtors in bankruptcy living in states that recognize a state law exemption for inherited IRAs may still be able have the inherited IRA protected (if the debtor has lived in the state at least 730 days and elects to have state exemptions apply instead of the federal bankruptcy exemptions).

Which State's Exemptions Apply? A particular state's exemptions apply to debtors who have a certain nexus with the state. This is described differently among the states. Examples: California-domicile; Connecticut-natural person; Florida-residing in the state; Georgia, residing in the state (but for annuities, "citizens or residents" [how does one become a "citizen" of a state?]); New Hampshire-person with respect to a homestead; and Virginia-householder.

30. Self-Settled Trusts; Inter Vivos QTIP Trusts

a. **Self-Settled Trusts.** There are now 15 self-settled trust jurisdictions, covering about 30-35% of the U.S. population. As the number of self-settled trust jurisdictions increases, public antipathy against them has diminished. An increasing number of clients that live in self-settled trust states are using self-settled trusts to some degree. (More uncertainties exist as to whether persons living in non-self-settled trust states can transfer assets to a trust governed by the laws of another state that recognizes self-settled trusts. A Bankruptcy judge may conclude that the public policy of the debtor's home state does not recognize self-settled trusts and precludes that state's residents from applying the self-settled trust laws of other states.)

   For an outstanding summary of the domestic asset protection statutes, see the ACTEC State Survey by David Shaftel, *ACTEC Comparison of the Domestic Asset Protection Trust Statutes* (updated through April 2014).

b. **Inter Vivos QTIP Trusts.** If assets that one spouse contributes to an inter vivos QTIP remain in the trust after the donee-spouse's death, with the original donor spouse as a discretionary beneficiary, traditional principles would leave the trust assets subject to the claims of the donor-spouse. Various states now have legislation providing that inter vivos QTIP trusts generally will not be treated as self-settled, even if the settlor might benefit by surviving the donee-spouse. These states include Arizona, Florida, Kentucky, Maryland, Michigan, North Carolina, Oregon, South Carolina, and Texas.

31. Migration as Fraudulent Transfer

The fraudulent transfer statutes apply to transfers of assets that are otherwise available for the satisfaction of creditors with the intent to hinder, delay or defraud any creditor. The term "transfer" includes every mode of disposing of an asset (that is currently available to satisfy creditors). Can the mere act of migrating to a jurisdiction that exempts additional assets from creditors' claims be treated as a fraudulent transfer? There is a "decent chance" that will be treated as a transfer; it is an issue "that can go either way." ("Creditors are much more brutal than the IRS.") "Do not try to make that analysis yourself; get advice from a creditors' rights attorney."

32. Bankruptcy and State Law Exemptions

A debtor in federal bankruptcy generally may take advantage of either federal exemptions or state law exemptions. Some states (Illinois as an example) require their residents to use the state law exemptions, not the federal law exemptions.

None of the state laws require being in a state for a particular period of time to take advantage of exemptions in a state. The Bankruptcy Code, however, requires that a debtor be domiciled in a state for 730 days before filing a bankruptcy petition in order to elect out of federal bankruptcy exemptions and into the state law exemptions for that state. If a debtor does not meet the 730 day test, it can apply the laws of the prior state in which he or she was domiciled if the debtor had lived in that other state for at least 180 days, unless the laws of that jurisdiction say the exemptions apply only to domiciliaries of the jurisdiction.

Items 33-36 are observations from a session by M. Read Moore—Non-Tax Choice of Law Issues for Clients Who Move in and Out of the United States

33. Significance of Which Country's Laws Apply

There are considerable differences in the laws among countries for three issues of principal importance: (1) Succession laws (dealing with the transmission of property); (2) Marital property laws (every country has special laws dealing with property owned by spouses); and (3) Tax laws (estate and gift tax, inheritance tax, and income tax).

34. Succession Laws of Major Importance

a. **U.S. Law.** Three main principles apply in the U.S.: (1) Testamentary freedom (no forced heirship except in Louisiana); (2) Spousal protection (elective share rights or community property protection); and (3) Common use of trusts. (The U.S. has the largest body of trust law in the world-more than all other English speaking countries combined. Trusts are not treated overly harshly for tax purposes in the U.S.; other countries tax trusts and transfers to trusts onerously.)

b. **Common Law Countries**. Common law countries' laws are generally consistent with the U.S. as to these main principles. (These countries include the U.K., Ireland, Canada [other than the province of Quebec, which is a civil law jurisdiction] , New Zealand, Australia, and others.)

   Testamentary Freedom. The principles of succession law, including testamentary freedom, are very similar (with no forced heirship).

   Dependent Relief Legislation. Various countries have dependent relief legislation preventing an individual from disinheriting persons he or she was supporting during life (including parents and children [even adult children]). This is a backdoor forced heirship; post-mortem relief is available if the supporting person disinherits the dependents.

   Trusts. Common law countries recognize trusts, although they are not used as widely as in the U.S. because of their harsh tax treatment in other countries. The applicable trust laws may be different; for example, other countries do not recognize spendthrift trusts-that is a U.S. invention.

   Spousal Protection. There are spousal protection devices (but not community property).

c. **Civil Law Countries.** Example civil law countries are Spain, France, Rome, Italy, Netherlands, Portugal, Germany, Japan, Switzerland, Brazil, Peru, and Mexico.

   Lack of Testamentary Freedom. Civil law countries have forced heirship. There are considerable variances among the countries' forced heirship laws. (For example, in Switzerland, an inheritance agreement can waive forced heirship rights.)

   No Trusts. Trusts are an English invention. Civil law countries use other arrangements.

Community Property. Community property began in Rome, and the community property principles developed under Spanish and French law filters.

d. **Mixed Jurisdictions**. Some jurisdictions have elements of both civil and common law. These countries include Scotland, South Africa, Quebec, Puerto Rico, and the Philippines. In addition, the state of Louisiana has elements of both.

e. **Islamic Countries.** Islamic countries apply very rigid succession principles, based on Sharia law. There are detailed rules broadly mandating how property passes (daughters receive half-shares compared to sons, etc.).

35. General Choice of Law Approaches

a. **U.S.** The general choice of law principle in the U.S. is that the *lex situs* concept applies to real estate and the domicile concept applies to personal property.

Marital Property. For marital property, the spouses can choose the applicable rules (for example, in a marital agreement). In the absence of an agreement, personal property follows the law of the domicile and real property follows the law in the location of the property.

Trusts. A settlor of a trust can generally control the choice of law in the trust agreement. Choice of law provisions are not found in wills (and are not possible for intestate succession).

b. **Other English-Speaking Countries.** Other English-speaking countries also apply *lex situs* for real estate and law of the domicile for personal property.

c. **Islamic Countries.** Islamic countries do not have the concept of a choice of law. The relevant country's version of Sharia law is applied, with no ability to choose another law to apply.

36. E.U. Succession Regulation ("Brussels IV")

The European Succession Regulation No. 650/2012 of July 4, 2012 (also known as Brussels IV) creates a new set of private international law choice-of-law rules governing cross-border successions for persons who die on or after August 17, 2015. The regulation was adopted by all of the E.U. countries except the U.K., Ireland and Denmark.

a. **Major Shift—Apply Law of Habitual Residence**. Most E.U. countries previously applied the succession laws of the decedent's country of citizenship (or "nationality"). In a major shift, the law of the decedent's habitual residence will be applied. The Regulation does not have a specific definition of "habitual residence" but that term is used in other E.U. regulations and is known to have a generally accepted meaning. The key is an intention to reside in a country on a "lasting" basis, which could mean on a permanent or indefinite basis. Like domicile, this is a matter of intent and more than day-counting is required.

b. **Universal Application.** The law of the decedent's habitual residence applies to all property, wherever located. Therefore, if the decedent lives in the U.S., the E.U. countries will apply U.S. succession law principles even to real estate located in the

E.U. (avoiding forced heirship)—except for the possible *renvoi* application discussed below.

c. **Possible Exception.** The applicable law will be the country of habitual residence at the time of the decedent's death unless the deceased was "manifestly more closely connected" with another state or unless an E.U. country state determines that applying the law of another state would be "manifestly incompatible" with the public policy of the E.U. country.

d. ***Renvoi* Application**. If the law of habitual residence applies (say New York law for a New York resident who owns property in France), will not only the substantive succession law but also the choice of law provisions of New York (which applies *lex situs* for real property) be applied, so that the law of where the property is located, France, will control (with forced heirship)? Prior to the E.U. Regulation, countries differed as to whether they would "accept *renvoi*" (a French word meaning "send back") to apply the law of the situs rather than otherwise applicable law. (Germany is one country that clearly would accept the *renvoi* choice of law "send-back" to German law.)

   Under the E.U. Regulation, the E.U. member state will accept *renvoi* and apply its local law to succession matters related to property located in that member state that is owned by a decedent with his habitual residence in another jurisdiction. *See* E.U. Succession Regulation Art. 34(1).

e. **Ability to Elect to Apply Law of Country of Citizenship.** Very importantly, the testator can instead choose in his will to apply the law of his nationality (regardless of whether that state of nationality is a member state). This is important as a way of avoiding the *renvoi* to apply the law of the E.U. country under the *lex situs* principle.

   This approach may avoid forced heirship that would otherwise apply. For example, if a New York domiciliary and resident owns real estate in France, under the general principle of the EU regulation, New York law should apply to the succession of the worldwide assets (including the French real estate) because the habitual residence is in New York. But this includes the New York conflicts of law rules, and under New York law, the succession of real estate is governed by the law of the situs, leading back to the application of the French forced heirship rules. However, the regulation allows the New York citizen to elect in his will to have the New York succession law apply, which would exclude the forced heirship rules.

   Similarly, if a U.S. citizen who is a habitual resident of an E.U. country chooses U.S. succession law to apply, that choice of law does not include the U.S. choice of law rules (*i.e.*, *lex situs*), so the U.S. succession laws would control (avoiding forced heirship). E.U. Regulation Art. 34(2).

   Planning Tip: Including such an election in wills is very important for U.S. citizens owning real estate in a foreign country in any of the E.U. member states covered by the E.U. regulation or who may be moving to one of those member states. Another planning alternative might be to own the real estate in an entity.

Items 37-43 are observations from a session by Matthew G. Brown and Daniel S. Rubin—Leaving on a Jet Plane? Tax and Tax-Related Considerations for Individuals Moving Between States. This program particularly focused on the state tax systems of California and New York (as examples of issues that arise from various state tax systems.

37. How Much Migration Is Attributable to Tax Savings?

An August 18, 2014 *Washington Times* article suggests that the low tax burden in Florida has caught the attention of nearly two million people over the last several decades. Tax motivations may not be primary motivations, however. The migration to South Dakota and Alaska is low even though they are low tax states. The Center on Budget and Policy Priorities concludes that the extent of migration is low (just 1.7% of U.S. residents have moved states per year from 2001 thorough 2010), and they do so primarily for new jobs, cheaper housing, or a better climate.

38. Income Tax Rates in California and New York

a. **California.** California has the highest income tax rates in the country-up to 13.3%. California retroactively increased its tax rates in 2012. Rates are scheduled to drop in 2019, but many are skeptical that will happen. (As Milton Friedman says, there is nothing as permanent as a temporary government program.)

   California also has Noneconomic Substance Transaction ("NEST") penalties for abusive transactions (even if they are not "listed" transactions). It is a 40% penalty and a doubling of the late payment penalty. There is no objective process for determining if the penalty applies-it is in the auditor's discretion, and the only way to litigate is to pay the tax and sue for a refund.

   The California Franchise Tax Board is extremely aggressive, and very anti-taxpayer. One auditor has stated "we just write it up; it's their problem to litigate."

b. **New York.** New York has a maximum income tax rate of 8.82%, and New York City imposes income tax at a maximum rate of 3.876%. The combined maximum rate for New York City residents is a combined 12.676%.

39. Income Sourcing Rules for Residents, Non-Residents, and Part-Year Residents

a. **Significance**. States typically tax income "sourced" in the state (for both residents and non-residents) and tax the entire taxable income of residents. Thus, the sourcing rules are especially important for non-residents.

b. **California Sourcing Rules.**

   Generally. All income derived from California real or personal property located in the state—income from business carried on within the state and income from tangible or intangible personal property having a taxable situs in the state—is subject to California income tax when earned.

   Single Sales Factor for Corporate Taxpayers. Sales from *services* are presumed to be sourced to California if the purchaser received the benefit of the service in California, from sales of *intangible property* to the extent the property is used in California, and

from the sale or rental of *real property* or *tangible personal property* if it is located in California. (Previously, a three-factor method was used based on sales, property location, and the number of employees in California. The new single-factor test increases the California tax. For example, a Nevada attorney providing services to a California resident arguably has to pay the California tax. The system raises the specter of frequent double taxation, and the Multistate Tax Commission is concerned with this approach.

c. **New York Sourcing Rules.** New York source income includes income from (among others):

- Real property or tangible personal property in New York;
- Services performed in New York;
- A business, trade, profession, or occupation carried on in new York;
- A New York S corporation (but not a C corporation) in which the non-resident is a shareholder; and
- New York partnership income or gain; and
- New York estate or trust income or gain.

Interest, dividends, or gains from intangible personal property is not New York source income, unless it is received from carrying on a business in New York.

40. Like-Kind Exchanges

a. **Significance.** If a state resident enters into a like-kind exchange, but moves and later makes a disqualifying disposition in another state, does the initial state recognize any income? If not, the deferral mechanism of like-kind exchanges gets turned into an income exclusion as to the state where the original exchange occurred.

b. **California.** If a California resident disposes of real estate in a like-kind exchange in which the income recognition is deferred under §1031, the taxpayer must file Form 3840 every year until the gain is recognized to report the status of the replacement property. If the return is not filed in any year, California will consider the property sold and request tax on the deferred gain (they are very good at tracing like-kind exchange issues). California requires a Qualified Intermediary in California to act as custodian for all exchange funds. When the replacement property is disposed of (in a transaction that does not qualify for further like-kind exchange treatment), there is a *clawback* tax to California of the deferred gain from the sale of the California property.

c. **New York**. New York has no mechanism to assure that the like-kind exchange deferral does not result in an exclusion as to New York if the seller becomes a non-resident before the replacement property is sold.

41. Installment Sales

a. **California Migration Issues for Installment Sales.**

Resident Moves After Sale. If a California resident sells intangible assets or tangible assets located in the state on the installment method and later moves out of the state, the principal component of the later installment payments will be considered California source income, but the interest component of future installment payments will not be California source income.

Nonresident Moves to California After Sale. If a nonresident of California sells tangible property (even if it is located outside of California) and later moves to California and receives installment payments, both the principal and interest components of the payments received while a California resident will be taxable by California.

b. **New York**. If a New York resident leaves the state with an installment sale open, New York converts to an accrual basis for that individual. The result is that the gain is recognized on leaving New York, in effect, an expatriation tax. There is an option to avoid that tax on an accrual basis if the taxpayer (1) posts a surety bond for the full amount of the tax, and (2) continues to file New York returns to report gain on the installment sale.

If a non-resident sells New York property on the installment method, the special accrual rules do not apply and the taxpayer may report the income from the installment payments as they are received.

42. Taxation of Trusts/Benefciaries

a. **California.** California takes trust income taxation to the edge of constitutionality. California does not base taxation on whether the *settlor* was a resident, but look to whether the *trustee* or *beneficiaries* are located in California. California imposes tax on "the entire taxable income of a trust, if the fiduciary or [non-contingent] beneficiary … is a resident, regardless of the residence of the settlor."

California Fiduciary. Advisors, special trustees, or trust protectors are treated as fiduciaries for this purpose; anyone with direct or indirect power over trust property or with the power to direct or veto the trustee is a "fiduciary" for this purpose. If there are multiple fiduciaries, taxes are apportioned based on the number of fiduciaries resident in California.

California Non-Contingent Beneficiaries. A non-contingent beneficiary is one with a vested interest who is not subject to a condition precedent. Vested remainder beneficiaries are included. (California recently argued in a case that someone holding a testamentary general power of appointment was a non-contingent beneficiary for this purpose.) If there are multiple non-contingent beneficiaries, California taxes trust income "according to the number and interest of beneficiaries resident in" California.

Throwback Rules. (i) *Contingent beneficiary becomes non-contingent beneficiary.* If no California tax is paid on current or accumulated trust income because a resident beneficiary's interest was contingent, the trust income will be taxable to the beneficiary when the interest becomes non-contingent (*i.e.*, "when distributed or distributable" to the beneficiary). California allows a credit for income taxes the trust paid to another state, and allows beneficiaries to exclude income accumulated before

they reached age 21. (ii) *Distributions to former residents.* The throwback tax does not apply to former California residents who were contingent beneficiaries (so the trust paid no California tax) and who move to another state before receiving distributions, even if they were resident during the accumulation period. (But there is a presumption of California residency if the taxpayer leaves California within 12 months before the distribution and returns within 12 months after the distribution.)

b. **New York**. A resident trust is one for which the *settlor* was a New York resident. Under the general rules described above, resident trusts are taxed in New York on all trust income, and non-resident trusts are taxed only on New York source income.

Exempt Resident Trusts. Trusts established by New York residents (New York Resident Trusts) are generally subject to the New York income tax unless the trust has no New York trustees, no New York tangible property or real estate, and no New York source income. Such trusts created by New York residents that are exempt from the New York income tax are referred to as Exempt New York Resident Trusts.

Throwback Rules. Even though undistributed income from an Exempt New York Resident Trust is not subject to income tax in the year the income is received by the trust, *distributions* from the trust to a New York resident beneficiary after 2014 will be subject to New York income taxes with respect to certain accumulations of trust income. This "throwback" tax will not apply to income that was earned by a trust in a taxable year that started either (i) before January 1, 2014, or (ii) before the beneficiary first became a New York resident. There is no interest charge on the throwback tax. Capital gains are not typically considered income for these purposes (if the capital gains are not included in distributable net income).

Incomplete Gift Non-Grantor Trusts. "Incomplete gift non-grantor trusts" are trusts formed in a state with no income tax (often Delaware or Nevada, in which event they are referred to as "DING" or "NING" trusts) for the benefit of the grantor and other persons. The purpose of the trust is typically to accumulate income in the trust that is not subject to state income taxation in the state where the trust is located and not included in the grantor's income for state income tax purposes. Under recent legislation, such trusts created by New York residents are deemed to be "grantor trusts" for New York income tax purposes, which results in the income being included in the New York grantor's income whether or not the income is distributed to the grantor. This provision is effective for income earned on or after January 1, 2014, but not for trusts that were liquidated before June 1, 2014.

43. Gift and Estate Tax

a. **California.** California has no gift or estate tax.

b. **New York.** Legislation enacted March 31, 2014 made significant changes to the New York estate, gift, and GST rules (in addition to adding the throwback rules and ING rules regarding trust income taxation discussed above in Item 42.b). The New York estate tax applies to New York residents and to real or tangible property located in New York for non-residents. (Shares in an apartment cooperative are treated as an intangible for this purpose. There are special rules for the treatment of S corporation

stock, and single member or multi-member LLCs regarding whether and the extent to which they are treated as intangibles.)

Basic Exclusion Amount. The legislation increases the "basic exclusion amount" (formerly $1 million) beginning for decedents dying on or after April 1, 2014. For annual periods beginning on April 1, the exemption will be as follows: 2014-2015, $2,062,500; 2015-2016, $3,125,000; 2016-2017, $4,187,500; 2017-January 1, 2019, $5,250,000; after January 1, 2019, equal to the federal estate tax exemption.

Phase-Out of Exclusion Amount. The basic exclusion amount determines the filing threshold and is used to determine the amount of any applicable credit (if any). In effect, the estate exclusion amount is phased out for estates between 100% and 105% of the exclusion amount. Estates greater than 105% of the basic exclusion amount have no exclusion amount.

Estate Tax Rate. The top estate tax rate is 16% (there was a proposal in 2014 to reduce it to 10%, but that did not pass).

QTIP Election. A QTIP election can be made for New York estate tax purposes even if a federal estate tax return is not required to be filed. If a federal return is filed and the QTIP election is made on the federal return, a New York QTIP election must also be made.

Gifts Made Within Three Years of Death. New York does not impose a gift tax (Connecticut is the only state with a state gift tax). For decedents who die as a resident of New York, gifts made after April 1, 2014 and before January 1, 2019 by the New York resident will be included in his or her estate for New York estate tax purposes if the person dies within three years of making the gift. Similar rules apply to non-resident decedents who made gifts of New York situs property while the person was a resident of New York.

GST Tax. The New York GST tax was repealed for estates of persons dying on or after April 1, 2014.

Items 44-48 are observations from a session by Professor Karen E. Boxx and William T. Hennessey—A Primer on Multijurisdictional Practice OR How to Cross the Border Without Getting Caught!

44. Unauthorized Practice of Law

Attorneys representing migrating clients may potentially face unauthorized practice of law issues to the extent they are advising clients who no longer live in their state or are advising regarding the law of another state.

In the 1980s and 1990s many states enacted unauthorized practice of law statutes designed to maintain the integrity of the legal profession and protect the public—but also to protect the livelihood of lawyers practicing in the state. Courts have generally defined the practice of law broadly. For example, Florida Bar v., Sperry (Fla. 1962) reasoned that if the advice "affect[s] important rights of a person under the law" and if, the person giving the advice must "possess legal skill and knowledge of the law greater than that

possessed by the average citizen," giving such advice constitutes the practice of law. That is an extremely broad definition. Even for advice that would not be the practice of law if performed by a non-lawyer, the same advice by an attorney can still be the unauthorized practice of law.

Consequences of engaging in the unauthorized practice of law include: (1) disgorgement of fees (that was the result in the Birbrower (Calif. 1998) case); (2) bar discipline for an ethics violation; and (3) criminal prosecution.

45. Model Rule 5.5

Rule 5.5 of the ABA Model Rules of Professional Conduct (MRPC) addresses the unauthorized practice of law.

a. **General Rule**. MRPC 5.5(a)-(b) says what a lawyer *cannot* do.

General Prohibition. MRPC 5.5(a) provides that a lawyer (i) cannot practice in a jurisdiction in violation of the legal profession in that jurisdiction, or (ii) assist another in doing so.

Prohibition on "Systemic and Continuous Presence." MRPC 5.5(b) says that unless otherwise allowed by other exceptions, a lawyer cannot "establish an office or other systematic and continuous presence" or represent to the public that the lawyer is authorized to practice law in the jurisdiction where the lawyer is not admitted to practice.

b. **Exceptions.** MRPC 5.5(c) provides exceptions, in effect, outlining what a lawyer *can* do in a jurisdiction in which he or she is not admitted to practice. As long as the lawyer has not been disbarred or suspended in any jurisdiction, the lawyer "may provide services on a temporary basis" in the following situations:

- *Local Counsel Exception*—the services are provided in association with a lawyer admitted in the local jurisdiction who actively participates in the matter;
- *Pro Hoc Vice Exception*—the lawyer is authorized by law or court order to appear in the proceeding or reasonably expects to be so authorized;
- *ADR/Arbitration Exception*—the services are reasonably related to a pending or potential arbitration, mediation or other alternative dispute resolution; and
- *Transactional Practice Exception*—the services "arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice.

The last transactional practice exception is the key exception for estate planning related matters. (It is discussed below in more detail.)

Even if one of the exceptions applies, the attorney must still satisfy the fundamental requirement of competence in the other jurisdiction (MRPC 1.1). Furthermore, the ACTEC Commentaries take the position that if the attorney intends to render service in a state where the attorney is not admitted, he or she should obtain the client's informed consent.

46. Which State's Ethics Rules Govern?

MRPC 8.5(b) says that for transactional matters, the ethical standards of the state "in which the lawyer's conduct occurred, or, if the predominant effect of the conduct is in a different jurisdiction, the rules of that jurisdiction shall be applied…." In the typical estate planning situation, advice will relate primarily to the jurisdiction the client will be moving to—so the ethics rules of the target jurisdiction will often apply. The lawyer may be subject to discipline in both jurisdictions, but the ethics rules of the target jurisdiction may govern. In any event, the attorney will want to comply with the ethical requirements of both jurisdictions.

47. Transactional Practice Exception

The transactional practice exception is a broad exception permitting cross-border services in many situations. The Annotation to MRPC 5.5 explains:

> "Subsection (c)(4) permits the temporary cross-border provision of legal services that do not involve litigation or ADR proceedings if they 'arise or are reasonably related to the lawyer's practice' where the lawyer is admitted. In this way, the Model Rules provide some latitude for transactional lawyers to provide legal services in jurisdictions in which they are not formally licensed."

The key tests to the transactional exception are (1) the services are provided on a *temporary basis* , and (2) are *reasonably related* to the lawyer's practice where he or she is admitted to practice law.

a. **Temporary Basis.** ACTEC Commentaries to MRPC 5.5 take a rather expansive view of what constitutes practice on a temporary basis. It indicates that a Chicago lawyer who provides estate counseling and gives advice under the laws of surrounding states (Wisconsin, Iowa, Indiana, and Michigan) regarding titling, tax and similar issues, or who prepares deeds or other documents relating to those jurisdictions would constitute practicing in those other jurisdictions on a "temporary basis." If the attorney travels to those states in connection with the advice, it is hard to tell when the lawyer has crossed the line from temporary basis to a "systematic and continuous presence" in the state.

b. **Reasonably Related**. Some of the important factors in determining whether the reasonably related requirement is met include the following situations: (i) pre-existing client; (ii) work stemming from a related transaction; (iii) existing transactions that cross multiple jurisdictions, or (iv) the representation involves an issue for which the lawyer has a national expertise.

   As to the last "national expert" element, the official Comment to Rule 5.5 refers to "the lawyer's recognized expertise developed through the regular practice of law on behalf of clients in matters involving a particular body of federal, nationally-uniform, foreign, or international law."

   There are significant variances among state laws as to the elements required to meet the transactional practice exception. Some states have developed the exception through court rules rather than ethics rules. Some states require the attorney to register with the state and pay a fee (e.g., New Jersey, Nevada, and Connecticut).

Connecticut recognizes the exception only if the other jurisdiction recognizes the exception. A number of states require that the representation be related to work for an *existing client* in the licensing jurisdiction. (That is much more limiting than a "reasonably related to the attorney's practice" standard.)

c. **Application of Transactional Practice Exception in Hypothetical Scenarios**.

Advance Directives for a Client Spending Time in Another State. A New York lawyer's New York client spends some time in Florida and wants to have health care documents in Florida. This would come within the transactional practice exception, and meets the temporary basis test. Red flags are (i) the attorney should be competent to prepare the Florida documents (Model Rule 1.1), and the attorney should obtain the client's informed consent for giving advice regarding a jurisdiction in which the attorney is not admitted.

Supervising Execution in Other Jurisdiction. The New York attorney travels to Florida to review the documents with the client and to supervise the execution of the documents. The mere presence in Florida is permitted—and the representation is allowed as long as the attorney satisfied the "temporary basis" requirement.

Migrating Client Wants Existing Attorney to Update Estate Planning Documents. A New York client is moving to Florida and wants her long time New York attorney to update her estate planning documents. Under the Model Rule version of the transactional practice exception, this is permitted: it is temporary and reasonably related to the New York practice. Under the Colorado version, it may be questioned because Colorado prohibits soliciting or accepting Colorado clients. After the client moves to Colorado, she literally would be a "Colorado client." In this type of transaction, the ever-present fundamental requirement is that the New York attorney is competent to provide the Florida advice (in light of Florida-specific rules regarding homestead, powers of attorney, etc.), so the New York attorney would likely want to engage a Florida attorney for local advice.

National Expert. The New York client who moves to Florida wants the existing New York lawyer to prepare a GRAT in light of the lawyer's recognized expertise. That meets the temporary basis and reasonably related requirements.

Neighbor in Client's New State Wants Client's Pre-Existing Attorney to Prepare GRAT. The New York client who moves to Florida talks with her neighbor about the wonderfully successful GRAT prepared by the New York lawyer, and the neighbor wants the New York lawyer to prepare a GRAT for him as well. This "pushes the envelope." The rules in some states require that the work be for an existing client or client in the licensing jurisdiction, and this would not meet that test; states with that language would not permit this representation.

Opens Office in Other Jurisdiction. The New York attorney develops a reputation in Florida and "sets up shop" and holds himself out as an expert, while making clear he is not a Florida lawyer. This violates the "no systematic and continuous presence" test in MRPC 5.5(b) and would not be allowed under the Model Rule (even though the attorney is a national expert).

Estate Administration. The New York client who moves to Florida dies and her husband wants the New York attorney to handle the estate administration. The New York attorney engages a Florida attorney to file an appearance in the Florida court, but the New York attorney handles most of the administration issues (including preparing the estate tax return). Probate is partly a transactional and partly a court proceeding The Florida rules dictate that when local Florida counsel is engaged in a multi-state matter, "the lawyer admitted to practice in Florida could not serve merely as a conduit for the out-of-state lawyer, but would have to share actual responsibility for the representation and actively participate in the representation." Comment to Fla. R. Reg. Bar 4-5.5. The Florida attorney must actually handle the Florida aspects and court matters. "The New York lawyer cannot just borrow the Florida lawyer's bar license."

48. Out-of-State Document Review

In many situations, an attorney advising about matters in another jurisdiction will want to engage local counsel in that other jurisdiction. In response to a Florida ethics opinion in 2003, one commentator questioned whether a Florida lawyer who reviewed documents for out-of-state lawyers could be aiding and abetting the unauthorized practice of law by the out-of-state lawyer. The Division Director for Ethics for the Florida Bar wrote a letter that was published making clear that such representation is allowed and encouraged:

> "… Florida attorneys are often asked to review estate planning documents drafted by out-of-state attorneys. This review is not improper and is in fact encouraged."

Various interesting ethical issues arise with represent to the local counsel in that situation. For example, if a Florida attorney reviews documents prepared by a New York lawyer regarding the Florida aspects related to the documents, the following ethical issues arise.

- *Who is the Client*? Is the New York lawyer the client or is the New York lawyer's client the client of the Florida attorney?
- *Scope of Representation*. MRPC 1.2 permits a lawyer to limit the scope of the representation if the limitation is reasonable and the client gives informed consent confirmed in writing. The engagement letter could make clear that the Florida attorney's representation is limited to local compliance.
- *Communication*. MRPC 1.4 requires a lawyer to communicate with the client. Must the attorney insist on direct communication with the client of the New York lawyer?
- *Fees*. MRPC 1.5(e) permits a division of fees between lawyers who are not in the same firm only if (a) the total fee is reasonable, (b) the division is in proportion to the services performed by each lawyer, and (c) the client agrees in writing, each lawyer assumes joint responsibility and is available to consult with the client, and the fee arrangement specifies the division of fees.
- *Confidentiality*. MRPC 1.6 requires a lawyer to keep information confidential unless it is reasonably necessary to serve a client's interest. Must the New

York lawyer request the client's permission to associate Florida counsel and discuss information regarding the client with the Florida counsel?

Items 49-63 are observations from a session by Bonnie Brennan (Christies in New York), Tash Perrin (Christie's in New York), Erin L. Prouty, Professor Anne-Marie Rhodes, and Leslie Wright (Bonhams in Los Angeles)—What Your Clients Really Care About: Planning For and Dealing With Their Treasured Art and Collectibles

49. Art Exceptionalism

Professor Anne-Marie Rhodes, who has written extensively about art issues, says there is no such thing as "art law." Legal issues regarding art combines all aspects of law, but legal rules do not always apply in the normal ways to art issues.

50. Fair Market Value of Art; Commissions

Items 50-57 deal with art *valuation* issues.

The fair market value of art is based on the willing buyer-willing seller test, assuming the art would change hands in the relevant and appropriate marketplace. Fair market value includes the "buyer's premium." TAM 9235005. (The buyer's premium is a percentage additional charge on the "hammer price" (the winning auction bid) that must be paid by the winner to the auction house to cover its administrative expenses. The buyer's premium at major auction houses typically is 25%, with progressively lower rates for larger sale prices; a typical rate is 12% for pieces that sell for over $2 million.) In addition, the seller typically pays a commission (which may be around 10%), but the seller's commission is often waived for works of art worth $1 million or above.

The fair market value is not a precise mathematical calculation. There is a range of values and appraisals may report values at the low or high end of this anticipated range.

51. Art Appraisal Services; Commissioner's Art Advisory Panel

The Commissioner's Art Advisory Panel assists the IRS in evaluating art appraisals submitted by taxpayers in federal income, estate, and gift tax cases. The Panel consists of up to 25 renowned art experts, who serve without compensation. All returns selected for examination that include art with a claimed value of $50,000 or more are referred to the IRS Office of Art Appraisal Services for possible review by the Commissioner's Art Advisory Panel. Art valued at $50,000 or more must be valued on the basis of comparables. The Art Panel meets twice a year. There is about a 1 ½ - 2 year delay from the time that an art item appraisal is referred to the Art Panel. There are rumors that the threshold may be moving to $100,000 or more to alleviate the backlog that the Art Panel is facing.

52. Types of Appraisals for Art

Purposes of obtaining art appraisals include insurance, estate tax, gift tax, charitable donations, financial planning (including planning for equitable distribution), establishing cost basis, divorce, loan collateral, and rental planning.

Avoid using an appraisal for a different purpose than the purpose for which the appraisal was prepared.

Appraisers typically do not like to get involved in someone else's dispute, but if both spouses agree, will do appraisals for divorce purposes.

Christie's has developed a methodology for making fair rental value appraisals, which can be helpful for sale/leaseback or gift/leaseback planning.

53. Appraiser Alternatives

a. **Auction Houses**. The representatives of the auction houses acknowledged that they are biased, but believe the best approach is to contact the Trust and Estates department at an auction house to appraise (or estimate the value of) art items. They have many specialists that work with them. The department can provide estimates of value free of charge; there is a charge for appraisals.

b. **Experienced Appraiser**. If an auction house is not used to make the appraisal, choose an appraiser with experience in the particular type of item being appraised. The importance of using an experienced appraiser is illustrated in the *Elkins v. Commissioner* case (767 F.3d 443 (5th Cir. 2014), *rev'g*, 140 T.C. 86 (2013). After submitting several appraisals to the IRS (unsuccessfully), the estate engaged an appraiser who could deal with both impressionist and modern art, with 48 years of experience, and who had been a member of the art panel for 17 years. He knew from looking at photographs the prior appraisers had used that he would need to look at the works in person (which had not been done previously). Using the highly experienced appraiser set the estate for success.

c. **Sub-Markets**. There are many sub-markets in the art and collectibles world, and using an appraiser who is experienced in the relevant sub-market is very important. For example, the post-war and contemporary art market is now "hot," with recent auctions setting new records. When the market is down in one sub-market it will up in another. The major auction houses will have sales twice a year in each of the various sub-markets.

54. How to Find Out If Appraiser is Qualified

- Questions to ask the appraiser:
- Background and education
- How long has the appraiser been involved in the art world, and in the particular type of art being appraised?
- How long as the appraiser been preparing art appraisals and appraisals in the particular sub-market?

- Has the appraiser prepared appraisals of this type and scope previously?
- How frequently?
- Is the public market familiar with the appraiser?
- Has the appraiser been involved previously in IRS audits and IRS meetings with examiners (if the appraisal is being used for tax purposes)?

55. Updating Appraisals

How often art appraisals need to be updated depends on the type of art. The post-war/contemporary market is changing every six months. For old masters, updating the appraisals every several years should be sufficient.

Do not assume that an appraisal can be updated by adjusting the appraisal upward or downward by a set percentage for multiple pieces of art.

As an example, some time ago a client gave a Monet painting to a son and a Corot painting to a daughter, thinking that they had approximately equal values at the time of the gift. Twenty years later, the markets had shifted substantially (the record for Corot was $4.75 million and $80 million for Monet.)

56. Legal Determinants of Value

The major legal determinants of value for art are *authenticity* and *good marketable title*. (Each of those fit into the concept of "art exceptionalism.")

a. **Art Authenticity.** Art authenticity is not static. There will be a consensus opinion about the authenticity of a particular piece, but it can shift over time. For example, a research project by Dutch historians began in 1968 regarding the authenticity of Rembrandt paintings. Various surveys had been reducing the number of authentic Rembrandts from 711 in 1921 to 420 in 1968. The number of paintings that the panelists could agree upon as authentic Rembrandts was considerably lower-about 300.

   There are three major factors leading to authenticity problems: (i) Forgery; (2) Mistake and misattribution; and (3) "Not authentic enough."

   Forgery. Intentional deception and forgery obviously present authenticity problems.

   Mistake and Misattribution. An example of "mistake" is the experience of the famed Getty art museum. After become the director, Nicholas Turner believed various drawings in the collection were forgeries, and he was involved in messy litigation; the museum refused to make his speculation public. A particular well-known incident involves a seven-foot-tall Greek statue of a boy that the museum purchased in 1985 for $7 million. The museum eventually sponsored an international colloquium on the authenticity of the statue, and it now is accompanied by a wall panel that reads, "Circa 530 B.C. or modern forgery."

   Various cases have addressed whether statements by a seller were mere *opinions* or whether they constituted *warranties* that the work was authentic. In *Dawson v. G. Malina, Inc.*, (SDNY 1978), the court, in applying an art specific New York statute

concerning warranties, concluded that the determination of liability should be made on an item-by-item basis. If the dealer could show that it had a reasonable basis to say a particular piece was authentic, there was no liability because authenticity is fluid and consensus opinion can change over time. So what appears to be a warranty might not be. Many auction houses give a 5-year warranty of authenticity, but reserve the right to rescind the sale if authenticity is later questioned.

Not Authentic Enough. As an example, an Agam sculpture in Chicago, deteriorated over time and the owner restored it. When Agam saw it, he disavowed it as the new colors were not what he intended. The Visual Artists Rights Act can raise concerns; it gives artists the right to prevent the use of one's name on any work that has been distorted, mutilated, or modified in a way that would be prejudicial to the artist's honor or reputation.

Tools Used by Art Industry to Determine Authenticity. Three approaches typically used to determine authenticity are:

- *Provenance*-a written compilation of the chain of possession, generally including exhibition history and bibliography;
- *Scientific analysis*-including things such as dendrochrononology (determining age and felling date of tree of the wood used in the painter's panel), textile research, paint sample analysis, X-ray images and other radiographic research, and forensic analysis of handwriting; forensic analysis is generally unsatisfying in proving authenticity-it is better at proving inauthenticity;
- *Connoisseurship*-the visual inspection of the work by the "trained eye" is the most preferred method in the art work, and this is highly subjective.

b. **Good Title**. If there is a theft, the law will not favor the thief. The legal issue arises between innocent owners vs. bona fide purchasers for value. The U.S. legal system prefers legal owners, but the civil law system prefers the bona fide purchaser for value. A key is the owner's due diligence, to alert authorities if something is stolen, and to notify the Art Loss Registry ("ALR"). Due diligence of the owner whose art has been stolen may be the tipping point on the ability of the owner to prevail in an action against a bona fide purchaser for value.

There are three dominant factual contexts for stolen art in the U.S.:

(1) Classic theft (works valued at over $500 million stolen from the Isabella Stewart Gardner Museum in 1990 have never been recovered);

(2) War-looted art, especially Nazi-era transfers (the recent movie "Woman in Gold" tells the story of the recovery of Gustav Klimt's *Portrait of Adele Bloch-Bauer I* [*see Republic of Austria v. Altmann,* 541 U.S. 677 (2004)]), as well as Russian revolution and Cuban revolution looting; and

(3) Antiquities looting (1970 is a key date); the 1970 UNESCO Convention on the Means of Prohibiting and Preventing the Illicit Import, Exports and Transfer of Ownership of Cultural Property, ratified in the U.S. by the Convention on Cultural Property Implementation Act of 1983 (CPIA) allows for stolen objects to

be seized if there is documentation of the objects in a museum or institution of a state party.

Additional issues to be considered in determining marketable title are (1) restricted materials in the work (for example, ivory, tortoiseshell, rosewood or migratory bird feathers), and (2) liens or encumbrances against the work. An example of the restricted materials problem is that a decedent's estate owned a Rauschenberg work, *Canyon*¸ that included a taxidermied eagle jutting out from the painting. The art could not be sold because selling or trading an eagle (dead or alive) is illegal. The estate reportedly valued it a $0 and the IRS valued it at $64 million. The tax dispute was resolved by an agreement that the estate tax would be zero if the work would be left to a public institution; it is now in the Museum of Modern Art in New York. (There have been several other cases in which the IRS also contended that art works had to be valued within the illegal market.)

57. Art Market Factors That Affect Value

Major factors in the art world that affect the value of a piece are rarity, condition, and provenance.

Rarity. Rarity can be a double-edged sword. For example, a relatively rare Warhol work from an early style was not well received in sales because it was not indicative of the Warhol style.

Condition. The importance of condition varies in different sub-markets. In the Chinese art market, condition matters dramatically; a hair line crack on the back of dish resulted in the piece being worth about 20% of the value of a comparable piece.

Provenance. Appraisers look at the intrinsic value of an item, not its provenance *(i.e.,* the record of its ownership). Provenance, however, can greatly impact the value when the work is sold. As an example, items of jewelry from the Elizabeth Taylor or Lauren Bacall collections sold for significantly over their estimated value.

Authenticity. If the authenticity of a piece is merely questioned, value can be impacted significantly. In *Doherty v. Commissioner (9th Cir. 1994),* the value of a painting, *Attacking Stagecoach,* purported by Charles Russell , was discounted in value because of disputes over its authenticity.

Other Factors. Oil paintings are generally more valuable that water colors or drawings. Certain periods of an artist's work may be more valuable than others. Bigger is not always better (for example, rugs-not everyone can accommodate a big rug).

58. Monetizing Art Collections

a. **Auction Sale**.

Appropriate Marketplace. Is the art something that will sell better on an international stage in one of the large auction houses, or could it sell well in a regional market or smaller auction house?

Auction Estimates. Auction estimates (a range of values) are provided free of charge and are an important marketing tool in presenting a work at auction and are very different from single-appraisal figures used for IRS purposes.

Reserves. The reserve price is the minimum price at the auction. It is a confidential amount—but is never higher than the low estimate.

Auction Timeline. Planning typically starts about 3-4 months before a scheduled sale season. Steps during the auction planning process include inspections, preparing estimates, negotiating contract of sale, shipping art to the auction house, cataloguing and researching, marketing (catalogs are distributed 30 days before the auction), and pre-sale exhibitions. Settlement (payment to the seller) occurs 35 days following the auction.

"Enhanced Hammer." The seller's commission is often waived for sales of works above about $1 million. For the most expensive works, the seller can receive 4-7% of the hammer price, in effect receiving part of the buyer's commission. This is referred to as an "enhanced hammer."

Advance of Sale Proceeds. The auction house may be willing to advance up to 50% of the low estimate range for sales of more expensive items (advance minimums are usually in the range of $500,000). The advance is repaid from the sale proceeds (plus interest).

Guarantees. In some cases, the auction house may negotiate to pay a guarantee, offering a minimum price to the seller regardless of the auction price. Any amount received above the minimum amount is shared with the auction house in a predetermined negotiated amount. The auction house may negotiate with an outside investor who promises to buy the work for a minimum price (and that investor typically receives a share of any amount above the minimum price.) Alternatively, the auction house may guarantee works themselves. *See* Graham Bowley, *The (Auction) House Doesn't Always Win*, New York Times (Jan. 15, 2014).

b. **Private Sales**. Private sales may be more favorable than auctions for some types of art and for some situations. Works by artists with a strong regional following may fare better in a private sale. Another advantage is that the buyer does not have to wait until the next sale season for the auction to occur and risk a volatile market (for example a gold specimen subject to the volatilities of gold prices).

c. **Like-Kind Exchange**. Tax deferred like-kind exchanges are available for art (though the Obama administration has proposed that like-kind exchange treatment should not be available for collectibles). This defers a federal tax of 28% (the tax rate on the sale of collectibles, including art) plus the 3.8% rate on net investment income. Like-kind exchange treatment for art is available only if the art is part of an active trade or business or is held for investment purposes (which generally means the art must be in storage and not in the investor's home). The exchange must be like-kind (for example, a painting for a sculpture will not qualify). One piece can be exchanged for up to three pieces. The exchange must be completed within 180 days.

d. **Sales and Use Taxes**. Sales taxes apply in many states. However, occasional (less than three within a 12-month period) sales to dealers are typically exempt from the

sale tax. In addition, works that will be shipped out of state are typically exempt from the sales tax (but may be subject to a use tax in the state to which the work is shipped).

For purposes of the use tax, the location of the "use" is where the property is used for the first 90 day after the purchase. There are creative ways of avoiding the use tax. Five states have no use tax: Alaska, Delaware, Montana, New Hampshire, and Oregon. Some purchasers have sent their purchased art to the art museum in Portland, Oregon, for the initial 90 days. Professor Rhodes is aware of a situation where doing that with the sale of a Francis Bacon piece last year saved $11 million of use tax. The Portland Art Museum does that frequently.

e. **Resale Royalty Act.** The California Resale Royalty Act entitles artists to a royalty payment upon the resale of their works of art under certain circumstances, including that the seller reside in California or the sale is made in California, the work is sold by the seller at an appreciated price, the work is sold or exchanged for $1,000 or more, and the work is sold during the artist's lifetime or within 20 years of the artist's death. Many European countries have similar laws (for examples sales in London are subject to the Resale Royalty Act).

f. **Lending Against a Collection**. Many banks, as well as some auction houses, offer loans with art collections as collateral. The loans may be up to about 25%-50% of the value of the collection. Some loan terms can extend for the client's lifetime, and funds can be repaid from a sale generated after the estate is established. (This not only may solve a family's need for immediate liquidity, but may allow a basis step-up, eliminating the 28% plus 3.8% capital gains tax liability.)

59. Planning Non-Charitable Gifts

a. **Reasons for Lifetime Gifts of Art**. Art presents various complications for the family and planning the estate of the collector.

- The collector may be unsure what the executor will do with the collection.
- Administering the collection at death (including the sale) may be expensive.
- How the executor will distribute the art may be uncertain.
- Commissions and selling costs may not be deductible for estate tax purposes. The selling expenses will be deductible if the will requires that the art be sold, or if the art must be sold to pay estate taxes.
- The family's intentions may be unclear; the collector should discuss the art with the family members to find out their intentions. If more than one beneficiary is interested in the art, how will it be divided? If not all are interested in the art, will those wanting it be willing to accept it as part of their share of the estate?
- The tax apportionment clause must be reviewed if there are specific bequests of valuable art items (or estate taxes on the art could wipe out the residue).

- If there are many works by one artist (or if the client is the artist), there may be a limit on how fast the collection can be sold without flooding the market.

A downside of lifetime gifts of art is that sales of art are subject to a special 28% capital gains rate (plus the 3.8% tax on net investment income). Making gifts of art will mean that the family gets no basis step-up at the collectors' death, resulting in the large tax bite when the family member later sells the art.

b. **General Tax Principles**. Gifts of art may qualify for the annual exclusion and the lifetime gift tax exclusion, with a gift tax of 40% on the excess. Gifts mean that a carryover basis applies, and no basis step-up is available upon the donor's death.

c. **Discounting Art Transfers.**

Fractional Interests. The law is in a state of flux regarding *fractional interests* in art. The *Stone* case (9th Cir. 2009) allowed a 2% discount for the cost of partition and 3% for uncertainties. The *Scull* case also allowed only a 5% discount. The recent *Elkins* case (5th Cir. 2014) allowed an overall fractional interest discount in excess of 65%, but the rationale was largely based on the failure of the IRS to produce any evidence regarding the amount of fractional interest discount that should be allowed for art, and the estate had qualified appraisals.

*Entity Ownership***.** Art in LLCs and partnerships is sometimes valued with discounts of 25-30%.There is some risk the IRS will treat the transaction as a direct gift of art, and the issue would then be back to the appropriate fractional interest discount.

d. **Gift-Sale/Leaseback.** A critical element of a plan for a donor or seller to lease back art is determining the correct fair rental value. If the donor/seller pays too little, there is a §2036(a)(1) estate inclusion risk. If the seller pays too much, there is a gift risk. There should be no income tax on the rental payments as long as the transaction is with a grantor trust. The rental payments remove assets from the estate that would otherwise be subject to estate tax.

e. **Charitable Remainder Trusts.** The donor can retain some benefit from the art (in particular from the sales proceeds) by using the charitable remainder trust (CRT). If the trust sells the art, there is no immediate income tax (because the CRT is a tax-exempt entity. A "Flip CRUT with make-up provisions" is often a good way to structure a CRT with art—provide that no unitrust payments are due until the flip event (because there may be no cash for making unitrust payments)—and that the flip event is the sale of the art.

f. **GRATs**. Art is rarely appropriate for GRATs. The art probably produces little cash flow. The art must be re-appraised each year if some portion is to be distributed back to the donor in satisfaction of the unitrust payments. Also, art typically appreciates over long periods-not over the period of a short-term GRAT.

60. Charitable Gifts of Art

a. **General Income Tax Deduction Limitations for Art.**

- The deduction is limited to the owner's basis unless the donee uses the art for a "related use". The donor must receive written acknowledgment from the charity that the work will be so used.
- The deduction is subject to recapture if the donated art is sold within three years of the contribution.
- The art will be ordinary income property if it was created by the donor, was received from the creator as a gift, was held as inventory by an art dealer, or was owned less than one year at the time of the sale. Art that is ordinary income property will have a basis equal to the material used to create the piece, and the sale proceeds will be subject to ordinary income tax rates.

b. **Qualified Appraisal.** A qualified appraisal is required if the art is valued at $5,000 or more.

c. **Filing Requirements**. Form 8283 must be filed with the donor's return if non-cash gifts exceed $500. For art worth more than $20,000, a copy of the appraisal must be attached to the Form 8283 and a color photograph of the work.

The charity must file Form 8282 to report its disposition of the art within three years unless the item was worth less than $500.

d. **Requesting Statement of Value From IRS.** After making a gift but before filing a gift tax return reporting the gift, the donor may request a Statement of Value" from the IRS under the procedures of Rev. Proc. 96-15 for works of art appraised at $50,000 or more. These are rarely useful. No Fellows at the seminar had ever made this request.

e. **Fractional Interest Gifts**. There are significant restrictions on gifts of fractional interests in art to charities. All of the interests in the art must be given to the same charity within the earlier of 10 years or the donor's death. If the donor dies before the ten-year period is up, the gift must be completed at that time. The value is determined at the time the first gift is made, and the deductions in later years are limited to the appropriate fractional portion of that same original value (even if the art has appreciated in the interim). The possession of the art must be based on the percentage ownership. No Fellow at the seminar has completed a fractional interest in art since these new rules were adopted under §170(o) of the Internal Revenue Code.

f. **Impact on Auction Sales**. If the purchasers at an auction are aware that the sale proceeds have been committed to a charity, the sales price is often favorable.

g. **Pledges**. No deduction is available until the art has actually been donated; no donation is allowed for merely making an enforceable pledge to donate a gift to charity.

h. **Restrictions on Gifts.** A donor might want to negotiate various restrictions such as (i) the collection will not be split up, (ii) the collection will be on display for a specified

period of time (museums are reluctant to do this because about 85%-95% of their collections are in storage and any such agreement should include an enforcement mechanism), (iii) assurances as to where the item will be displayed and in groupings with other particular works, (iii) the donor will receive a "credit line" whenever the item is displayed [query, could there be an issue as to whether that raises a §2036(a)(1) retained enjoyment issue?].

A particularly troublesome restriction request is for a "de-accession commitment" that the museum will not sell the item for a particular period of time or in perpetuity. Charities are particularly reluctant to provide de-accession agreements and especially de-accession agreements for a long period of time or in perpetuity.

The IRS has been fairly liberal in allowing deductions for gifts with restrictions. *E.g.,* PLRs 200202032, 200418002. In one case, the IRS required that a de-accession agreement in perpetuity be removed from the agreement.

i. **Talk With Museum in Advance.** Discuss plans for later donating art to a museum to determine whether the museum is even interested in accepting the piece.

61. Loans to Museums From Foreigners

Risks that foreigners have focused on in making loans of art to U.S. museums in the past have been for (1) damage and (2) theft. In the last 20-30 years, another risk is the risk of having items seized (particularly as a part of Nazi restitution programs). Under the Federal Immunity From Judicial Seizure Statute (22 U.S.C. 2459), upon proper filing with the U.S. State Department, the foreigner can have assurance that "any work of art or other object of cultural significance" will not be seized while in the U.S. for temporary exhibition or display.

62. Practical Planning Tips for Artists

The artist should sign everything. (Some artists have early works that may be hard to identify because they are not signed.)

Catalog and organize all works.

Take pictures of all works.

Write down facts about each piece of art; what inspired it, how it was created, etc.

63. Private Operating Foundations

Because museums exhibit only a small portion of their collections, an artist or collector might consider a private operating foundation to maintain a collection as a lending library of the art. The foundation will be responsible for storage, shipping, maintenance, etc, so there must be an endowment of financial assets to support the foundation. They are not cheap or easy; they are only feasible for a fairly substantial collection and endowment to cover expenses. Some of the basic planning considerations for operating foundations are as follows.

An income and estate tax deduction is allowed for gifts to the foundation under the deduction limitations for gifts to public charities.

If the foundation is created in the donor's lifetime, the donor cannot keep possession of the art; the foundation must be responsible for storing the art.

The foundation can conduct other activities, including scholarship programs, maintain a research library, creating endowments, supporting academic programs, making classes available to the public, etc.

A settlor may wish to convert a grantor trust to a non-grantor trust for various reasons: (i) the increase of the estate exemption to $5 million indexed together with portability may mean that the client no longer has estate tax concerns, (ii) the grantor may have transferred as much value as desired and no longer wants to keep paying income taxes on the trust's income, or (iii) having items of trust income continuing to appear on the settlor's income tax return may raise questions about the trust in an estate tax audit.

Merely having a trustee start to reimburse the grantor for such income taxes under a discretionary reimbursement power in the trust instrument may raise an issue as to whether an implied agreement existed that the trustee would do that when desired, thus causing the trust to be in the grantor's estate as a result of the implied retained control over the trust.

Conversion to a non-grantor trust may occur in various possible ways, depending on the terms of the trust, such as by relinquishing a beneficial interest of the grantor's spouse, a third party exercising a power to remove "trigger powers" that cause grantor trust status, changing trustees so that half or less are related or subordinate parties if the trust allows distributions without an ascertainable standard, or the grantor's release of a substitution power (among other possible methods). Very careful navigation of the grantor trust rules will be required.

Before relinquishing grantor trust status, carefully consider that keeping grantor trust status may be very helpful if the client wishes to substitute illiquid assets into the trust in return for liquid assets for living expenses or to reacquire low-basis assets before the grantor's death.