ACTEC 2017 Annual Meeting Musings

March 2017

The American College of Trust and Estate Counsel is a national organization of approximately 2,600 lawyers elected to membership. One of its central purposes is to study and improve trust, estate and tax laws, procedures and professional responsibility. Learn more about ACTEC and access the roster of ACTEC Fellows at **www.actec.org**.

This summary reflects brief highlighted individual observations of Steve Akers from some of the seminars at the 2017 Annual 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 brief observations from the 2017 ACTEC Annual Meeting Seminars in Scottsdale, Arizona on March 10-12, 2017, 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 from some (but not all) of the seminars. The summary is based on the presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-3 are observations from a seminar by Steve R. Akers, Miriam W. Henry, and Howard Zaritsky, Hot Topics

1. Planning In the Face of Legislative Uncertainty and Potential Estate Tax Repeal

a. **Legislative Process; Delays**. Tax reform will doubtless proceed under the reconciliation process to avoid a Senate filibuster. The actual process contemplated for 2017 involves having two reconciliation acts in the same year, which has not happened in the 43-year history of the Congressional Budget Act. That can occur because no budget resolution was passed last year for the October 1, 2016 – September 30, 2017 fiscal year. A 2017 fiscal year (FY 2017) budget resolution was introduced on January 3, 2017, which among other things addresses repeal of provisions of the Affordable Care Act. The plan was to complete a reconciliation act on that measure in April or May, 2017. Among other things, it would reduce or eliminate various mandates, taxes and penalties associated with the Affordable Care Act.

After completing the FY 2017 reconciliation act (that would repeal provisions of the Affordable Care Act), the plan was to introduce a FY 2018 budget resolution sometime in May or June 2017, with the goal of completing the reconciliation act by August 2017, and it would deal with tax reform.

Delays that have arisen in the discussion of the Affordable Care Act mean that the FY 2017 act likely will not be completed by April or May. Only one budget resolution can be active at a time; when a FY 2018 budget resolution is adopted, the FY 2017 budget resolution will no longer remain. Alternatives are (i) to wait on introducing the FY 2018 budget resolution until the FY 2017 reconciliation act dealing with the Affordable Care Act is completed (which would delay the time for considering 2018 appropriations and tax reform), or (ii) to adopt a FY 2018 budget resolution that could include reconciliation instructions for repeal of the Affordable Care Act AND tax reform (which would result in a "single, very large and extremely controversial reconciliation bill that could easily be enough to prevent the GOP from getting even a simple majority on their two highest legislative priorities"). Collender, *GOP Grand Scheme on Obamacare Repeal & Tax Reform Quickly Going South*, FORBES (Feb. 12, 2017).

Whether tax reform is accomplished in 2017 is becoming more problematic as each day passes with delays in dealing with "repealing and replacing" Obamacare.

b. **Avoid Paying Gift Tax.** Do not make such large gifts that significant gift taxes will be due currently. (No one wants to have the honor of being the last person in the country to pay gift tax.) A corollary of avoiding gift tax is to use defined value clauses in making gift or sale transfers to minimize unexpected gift tax consequences. Neither the Republican House tax reform plan nor the Trump tax reform plan explicitly state that the gift tax would be repealed.

c. **Great Uncertainty for Planning.** The "permanence" of the transfer tax following the "great compromise" made in the 2012 Act is now a laugher. Planning in the current environment of uncertainty about future tax laws is extremely difficult. Do we worry about removing assets from gross estates, or do we assure estate inclusion to achieve a stepped-up basis without any estate tax? Will we again see formula based estate plans, based on whether or not there is an estate tax, realization at death, etc.?

d. **Basis Step-Up?** The estate tax is not necessarily tied inextricably with basis step up under §1014. The income tax was enacted in 1913 and the estate tax in 1916. Neither mentioned anything about the basis of assets received from a decedent. The Revenue Act of 1921 included a rule about the basis of assets passing at death. A 1920 U.S. Supreme Court decision resolved an uncertainty about the provision, and in the mid-1930s Congress incorporated provisions under that reasoning. As string provisions were later added to the estate tax, the basis rules then started to track the estate tax. So, as a historical matter, there is no real linkage between the estate tax and basis step-up at death.

Additional Guidance Will Be Required. If basis step up is left in place with estate tax repeal, Congress will have to deal with the complexities of determining what assets passing from a decedent qualify for the basis adjustment under §1014(b). Section 1014(b)(9) now covers all property included in a decedent's gross estate under chapter 11. Probate assets will be covered by §1014(b)(1) ("[p]roperty acquired by bequest, devise, or inheritance"). What types of non-probate assets will also qualify for basis adjustment? For example, will assets in a revocable trust qualify? Assets subject to a general power of appointment by the decedent to appoint the assets to the decedent's creditors or estate? Assets that would have been includable under any of the string statutes (§§2034-2042)? Which string statutes will be included on that list? While no historical linkage exists between the adoption of the basis adjustment provisions and the estate tax, the basis step-up provisions have become parallel with the estate tax over the years, and in the absence of an estate tax, Congress will have to clarify the assets to which basis step-up applies.

QTIP Trusts. Would assets in a QTIP trust be entitled to a "second basis step-up" at the surviving spouse's subsequent death? If the estate tax does not exist, §1014(b) would have to be amended to provide a basis adjustment for assets that would have been included in the surviving spouse's estate under §2044 if the estate tax had applied. *See* §1014(b)(10).

Community Property Basis Adjustment. The community property basis adjustment provision in §1014(b)(6) is a good example of how estate tax repeal will have a collateral impact on the basis adjustment provisions. That section provides for the basis adjustment of both the decedent's and surviving spouse's one-half of community property at the decedent's death, but it only applies if at least one-half of the community property was included in the decedent's gross estate under chapter 11. If chapter 11 is repealed, the section obviously would no longer apply. Will the "double basis step-up" for community property survive repeal of the estate tax?

2. Same-Sex Marriage; Notice 2017-15 Allowing Recovery of Applicable Exclusion Amount and GST Exemption Allocation

Rev. Rul. 2013-17 clarified that for federal tax purposes (1) terms relating to marriage include same-sex couples, (2) a place of celebration standard is applied if a same-sex couple moves that a state that does not recognize same-sex marriages, and (3) the ruling does not apply to domestic partnerships or civil unions. It is applied prospectively as of September 16, 2013 (the date of the ruling's publication) but taxpayers may (but need not) file back returns within the standard limitations period for refunds if the recognition of the marriage results in lower taxes. In effect, the IRS implicitly acknowledged the retroactive application of unconstitutionality of the Federal Defense of Marriage Act ("DOMA"). *See also* Treas. Reg. §301.7701-18 (definition of "husband and wife" as meaning "two individuals lawfully married to each other").

While Rev. Rul. 2013-17 allows a refund for open years, it does not address whether, for closed years when a refund is not allowed, an individual's use of unified credit can be restored for purposes of subsequent gifts or for estate tax purposes at the individual's death. Regulation §25.2504-2(b) provides that if the statute of limitations has run on a gift tax return, the amount of the taxable gift resulting from that return, for purposes of determining the taxable gifts in prior periods when calculating later gift taxes, can never be re-determined. That applies to all issues relating to the gift including "the interpretation of the gift tax law." The constitutionality of that approach has been question, however, with respect to same-sex marriage issues in light of finding in *U.S. v. Windsor* [133 S. Ct. 2675 (2013)] that §3 of DOMA is unconstitutional.

Notice 2017-15 now clarifies that an individual who made a gift to a same-sex spouse that should have qualified for marital deduction, but for which the statute of limitations has run on obtaining a refund of the gift tax paid, may recalculate the remaining applicable exclusion amount as a result of recognizing the individual's marriage to his or her spouse. The Notice describes various procedures and limitations.

- Once the period of limitations has expired, neither the value of the transferred interest nor any position concerning any legal issue (other than the existence of the marriage) can be changed.
- The "taxpayer must recalculate the remaining applicable exclusion amount, in accordance with IRS forms and instructions [to be provided] on a Form 709 (preferably the first Form 709 required to be filed by the taxpayer after the issuance of this notice), on an amended Form 709 (if the limitations period under §6511 has not expired), or on the Form 706 for the taxpayer's estate if not reported on a Form 709."
- An amended or supplemental return need not be filed merely to report an increased applicable exclusion amount unless the taxpayer has predeceased the notice (i.e., died before January 17, 2017).

- Mechanics: (1) The taxpayer should add "FILED PURSUANT TO NOTICE 2017-15" at the top of the Form 709 or Form 706 that is filed to recover the applicable exclusion amount; and (2) A statement must be attached supporting the claim for the marital deduction and detailing the recalculation of the remaining applicable exclusion amount.
- If a QTIP or QDOT election is required to obtain the marital deduction, a separate request for relief pursuant to Reg. §301.9100-3 must be submitted.
- The notice does not extend the applicable time limits on making the split gift election under §2513.
- Any unrefunded gift tax paid, for which the period of limitations has expired, "will continue to be recognized as gift tax paid or payable for purposes of the computation of the estate tax under §2001." For a discussion of the effect of this provision, see George Karibjanian, *In Keeping with the Times, Treasury Goes "Retro" in IRS Notice 2017-15 for Same-Sex Marriage and Certain Transfer Tax Exemptions*, LEIMBERG ESTATE PLANNING NEWSLETTER #2514 (February 17, 2017) (suggesting that the gift to the spouse should not be added to the estate tax calculation as an adjusted taxable gift [because of the marital deduction that should have been allowed] on line 4 of Form 706, and therefore no amount is subtracted for the gift tax that would have been payable with respect to such gift on line 7 of Form 706, but the full unified credit is allowed as a credit against the estate tax on line 9d of Form 706; in effect, no specific credit is given for the prior gift tax paid, but the calculation often ends up with the individual paying less overall gift and estate tax than if the applicable exclusion amount had not been restored).
- IRS staff persons have indicated informally that taxpayers should not attempt to make this calculation before the IRS has released additional guidance and worksheets to clarify how the adjustment will be made.

If GST exemption was allocated to prior transfers because of the failure to recognize the marriage of the same-sex couple (for example, if the age assignment rules result in a GST transfer that would not have occurred if the spousal relationship had been recognized), the GST exemption will be restored using procedures similar to those described above for recovery of applicable exclusion amount.

3. Exercise of Substitution Powers With a Note (*Condiotti Irrevocable GST Trust* and *Benson v. Rosenthal*)

a. ***Condiotti Irrevocable GST Trust***. *In re The Mark Vance Condiotti Irrevocable GST Trust*, No. 14CA0969 (Col. App. 2015) addressed the exercise of a substitution power with a note. The trust agreement included a swap power for the grantor, but also stated that no one could borrow trust funds "without adequate interest or security." The grantor exercised the swap power by substituting a promissory note for the full value of the trust's corpus. The trustees (including the grantor's wife and a bank co-trustee) declined, arguing that this was not a substitution, but a loan, and that the note was not of equivalent value. The probate court held that the grantor was attempting to borrow the trust assets, and that his promissory note was worth less than the trust corpus. The Colorado Court of Appeals, in an unpublished opinion, affirmed, finding that the proposed transaction was an attempt to borrow from the trust, not to substitute assets, so that the trustees can properly reject it.

b. **Benson v. Rosenthal**. In *Benson v. Rosenthal*, 2016 WL 2855456 (E.D. La. 2016), trusts owned interests in the New Orleans Saints and Pelicans franchises, a television affiliate, and other businesses and investments. The trust agreements included a substitution power. The grantor expressed his intention to exercise the substitution power by exchanging the trust assets for notes of equivalent value (which included a valuation adjustment clause that adjusted the notes automatically to a later-determined appraised value) together with a transfer to the trust of certain real estate and the forgiveness of nearly $100 million of indebtedness that the trusts owed to the grantor. The trustee refused because an unsecured promissory note is "not an appropriate trust investment" and because the trustee must "make his own independent verification that the assets to be exchanged are of equivalent value [with the trust assets]" before the exchange could occur. The grantor sent additional documents including security. The trustee again rejected the exchange, stating there had "not yet been an exchange of assets of the equivalent value." The grantor retained valuation consultants to value the assets and delivered new secured promissory notes with specific values based on the appraisal. When the trustee again refused, the grantor filed suit to obtain a court declaration that the exchange was effective. The trustees moved to dismiss the suit either because (1) the exchange attempting was really a loan or (2) the substitution was ineffective.

The U.S. District Court for the Eastern District of Louisiana refused to dismiss the suit, distinguishing the *Condiotti Trust* case because unsecured notes had been proffered in that case. The court also observed that (1) the trust agreements did not explicitly exclude a promissory note from being used to exercise the substitution power, (2) the notes are assets having value, and (3) the real estate and loan forgiveness that the grantor offered as part of the substitution are further proof that a loan was not intended.

c. **Planning Considerations.** Howard Zaristsky provides the following summary of planning considerations.

> The problem of whether or not an exchange of a promissory note for assets of the trust is the type of exchange anticipated by Section 675(4)(C) will arise only in cases where the relationship between the trustees or beneficiaries of the trust and the grantor of the trust have soured significantly. That will be a minority of situations, but it will occur from time to time.
>
> The best advice that one can give, in light of the conflicting precedents, is that the grantor should hire an appraiser to appraise both any hard-to-value assets of the trust and the promissory note being proffered, and that the note should definitely be secured. Those two elements appear to be significant supports to the validity of a grantor's attempt to substitute assets by using a promissory note. If the trust expressly precludes the grantor from borrowing, however, the use of the substitution clause may be impaired.

Items 4-5 are observations from the Annual Joseph Trachtman Lecture by Hanson Reynolds. Mr. Reynolds discussed ways that doctors and attorneys may be able to assist patients and clients in addressing end-of-life decisions.

4. BEING MORTAL, by Atul Gawanda

The initial inspiration for the lecture was Atul Gawande's 2014 book, "Being Mortal." Dr. Atul Gwande championed the development of checklists for surgical procedures and the development of a team concept for sophisticated surgeries. He brings that learning to the manner in which doctors deal with end-of-life decisions for their patients and reflections on mortality.

a. **Tolstoy's DEATH OF IVAN ILYCH**. Dr. Gawande reflects that mortality was not studied when he was in medical school. The purpose of medical school was to teach how to save lives, not to tend to patients' demises. He remembers a one-hour class about Tolstoy's "Death of Ivan Ilych," published in 1886 about a high-court judge's sufferings and death from a terminal illness in 19th century Russia. After falling from a ladder, his physical condition worsened to the point that his physician realized the condition was terminal. As his condition worsened during the long and painful process of dying, the judge began to hate his family for avoiding the subject of his death, and pretending he was merely sick. The judge found his only comfort in a peasant servant, Gerasim, who showed compassion for him. These excerpts from the book vividly describe the feeling of this dying person and the loneliness arising from his family's and physician's refusal to pay attention to what really mattered to him.

> What tormented Ivan Ilych most was the deception, the lie, which for some reason they all accepted, that he was not dying but was simply ill, and that he only need keep quiet and undergo a treatment and then something very good would result.
>
> …
>
> And he had to live thus all alone on the brink of an abyss, with no one who understood or pitied him.
>
> …
>
> Apart from this lying, or because of it, what most tormented Ivan Ilych was that no one pitied him as he wished to be pitied. At certain moments after prolonged suffering he wished most of all (though he would have been ashamed to confess it) for someone to pity him as a sick child is pitied. He longed to be petted and comforted. He knew he was an important functionary, that he had a beard turning grey, and that therefore what he long for was impossible, but still he longed for it, and in Gerasim's attitude towards him there was something akin to what he wished for, and so that attitude comforted him. Ivan Ilych wanted to weep, wanted to be petted and cried over, and then his colleague Shebek would come, and instead of weeping and being petted, Ivan Ilych would assume a serious, severe, and profound air, and by force of habit would express his opinion on a decision of the Court of Cassation and would stubbornly insist on that view. This falsity around him and within him did more than anything else to poison his last days.

b. **Later Reflections**. Dr. Gawande put Ilych out of his mind after graduating from law school, but reflected on it much later. He contemplated whether physicians had developed an understanding of patient needs for some semblance of what was really important to them. The evidence was that medicine often fails to help the people that it intends to help, and the waning days of life are given to treatments that sap the patients' bodies with no sliver of hope. The harm inflicted denies the comfort that is most needed.

As patients near the end of life, decisions about their living situations by family members are primarily aimed at ensuring their safety at the expense of autonomy. Elderly patients are mistakenly treated as children when they are denied the right to make their own choices, even bad choices.

Various observations from Dr. Gawande:

> "Our reluctance to honestly examine the experience of aging and dying has increased the harm and suffering we inflict on people and has denied the basic comforts they need most."

> "Death is the enemy…. But the enemy has superior forces. Eventually, it wins. And in a war that you cannot win, you don't want a general who fights to the point of total annihilation. You don't want Custer. You want Robert E Lee … someone knows how to fight for territory that can be won and how to surrender it when it can't."

> "There is almost always a long tail of possibility, however thin. What's wrong with looking for it? Nothing, it seems to me, unless it means we have failed to prepare for the outcome that's vastly more probable."

> "Arriving at an acceptance of one's mortality and a clear understanding of the limits and the possibilities of medicine is a process, not an epiphany."

c. **Learning From Palliative Care Specialist**. Dr. Gawande reflected on things that he learned from a palliative care specialist at his hospital, Dr. Susan Block. She made him understand that explaining treatment plans in these situations requires skill, no less skill than is needed for conducting surgery. She advised to use an "ask, tell, ask" approach during a difficult discussion about a patient's prognosis. Ask what information the patient wants, tell the patient the information, and then ask what the patient understands.

Trying to learn what is important to the patient under the circumstances to help them achieve those goals requires as much listening as talking. "If you are talking more than half the time, you are talking too much." Use phrases such as "I wish things were different. If time is short, what is most important to you?"

Dr. Block uses a list of questions to cover before decisions are made. What does the patient understand about the prognosis? What lies ahead? What trade-offs are the patient willing to make? Is the patient willing to go through severe pain and rehabilitation to get a little additional time at the end of life? Or is the patient willing to give up additional time in order to have greater comfort and a return to regular life for as long as possible? How does the patient want to spend time if health worsens? Who should make decisions if the patient is not able to do so?

Dr. Block practiced her skills with her own father who was terminally ill. She asked him what level of being alive would be tolerable. Her father replied that if he could eat chocolate ice cream and watch football on TV, he was willing to stay alive. As her father declined, the family was asked whether to go through another surgery for him. Dr. Block asked the surgeon whether her father would be able to eat ice cream and watch football if he survived the second surgery. The answer was yes, so the decision was easy; Dr. Block knew what he wanted.

d. **Interpretive Approach**. Dr. Gawande concludes that the ideal approach should be neither *paternalistic* nor merely *informative* (and the way the physician presents the information can strongly impact the patient's choice – or feeling that no choice exists), but *interpretive* – helping patients determine their priorities and achieve them. Dr. Gawande's own father changed doctors during his terminal illness to find a doctor that allowed him to participate in decisions.

5. Implications For Estate Planning Attorneys

a. **General Approach.** Estate planning attorneys are intimately involved in their clients' testamentary plans. Dr. Gawande's reflections provide helpful insight for attorneys. What are the client's goals for the future – including what the client *really* wants and needs? In discussing alternatives that may result in estate, gift, and income tax savings, can we discuss trade-offs and risks in terms of what is most important to the client?

By comparison to Dr. Gawande's summary about the approaches of physicians, attempt to move to an interpretive approach (focused on determining what is most important to the client and discussing courses of action to achieve those goals) as opposed to a paternalistic or informative approach.

b. **Listening**. Listening to the client's broad important life goals can be more important than answering a set checklist of questions. "Have you talked more than half the time? Of course you have."

c. **End-of-Life Decisions.** The client's lawyer can help the physician by listening to clients to assist them in their thinking about end-of-life decisions. For the lawyer to say "that is not in my job description and I cannot get paid my normal rate" is not an appropriate answer.

d. **Practice Pointers**.

- Educate clients to be prepared to address what is really important to the client in making medical decisions.
- Give clients a copy of "Being Mortal" by Atul Gawande.
- Attorneys should develop their own checklist of issues to discuss with clients about end-of-life issues.
- Do not be discouraged if the client is not ready to discuss these issues.
- Make sure that estate plans anticipate the future (and anticipate the unanticipated).
- Determine at intervals if life changes may suggest changes in the client's plan.
- Listen carefully.
- Consider maintaining a list of assisted living facilities and nursing homes and whether clients have liked them or not.

e. **Prayer in Will**. Hanson told the story of one client who asked him if he could include a prayer in his will. The client considered this the most important bequest he could give to his descendants. The client wrote the following prayer, which was included in his will:

> Grand of all being and Father of all mankind,
>
> Let me bequeath to my descendants, even as I received from my ancestors,
>
> Glimpses of Thy nature, as revealed in science, in art, in meditation, in the wisdom of Thy historic church,
>
> Glimpses revealed through my friends, associates, forefathers and family, especially my parents--
>
> -In sunrise and sunset,
>
> -In Maine mornings,
>
> -In other joys and sufferings, which is most instructive,
>
> -In my temperament and vocation, which have enabled me to serve Thee in some degree in my lifetime.
>
> For all these insights and mercies, I thank Thee, and pray that I may extend some portion of these priceless riches to Robert, Anthony, Victoria and to their descendants.
>
> To my family I bequeath undying love.
>
> To all who desire my forgiveness, I give it freely, and ask for theirs.
>
> To Almighty God, I bequeath my soul, with the prayer that in the world to come, I may understand and do His will more perfectly than in this.
>
> Amen.

Hanson says he has never included another prayer in a will, but that prayer strikes him as a lovely inspiration – the spirituality, the Maine mornings, the sunrise and sunset, and the gifts to his descendants.

f. **Secret of a Long Happy Marriage.** A couple who was one of Hanson's clients (authors of the "Curious George" books) was asked the secret to their long happy marriage. The husband responded, "Early in our marriage, we agreed Margaret would make the everyday decisions and I would make the important decisions. So far, there haven't been any important decisions."

Item 6 is on overview of observations from a Symposium by John F. Bergner and Brian Hill (Computer Forensic Services), Planning for Privacy in a Public World: The Ethics and Mechanics of Protecting your Client's Privacy and Personal Security

6. Adapting Estate Planing Practices to Changing Times

a. **Important Often Overlooked Issue for Clients.**. Raising the consciousness of clients and assisting them with privacy and personal security concerns is an important service that planners can provide that is independent of the uncertainty surrounding the possibility of estate tax repeal. The planner can assist the client in balancing, in the client's particular situation, the need and desire for privacy and security with the inconvenience and cost impact that various alternatives will require. The attorney can raise a wide variety of issues with clients, which they may find very important after having the issues brought to their attention.

b. **Important Issues**. A summary of the information presented in the symposium is available at Item 10 of the Heckerling Musings 2017 and Estate Planning Current Developments (March 2017) found **here** and available at **www.Bessemer.com/Advisor.**

Among the issues summarized, which the client may find important once the attorney brings the issue to the client's attention are the following:

- Revocable trust to avoid disclosure of assets;
- Limiting disclosure of information to trust beneficiaries;
- Titling real estate and other assets to preserve anonymity;
- Anonymous charitable giving alternatives;
- Anonymous political contributions;
- Financial privacy planning;
- Medical privacy;
- Non-disclosure agreements;
- Litigation alternatives for privacy;
- Securing privacy at death;
- Cybersecurity; and
- Personal security.

Items 7-13 are observations from a Symposium by Steven B. Gorin and Clinton Eugene Wolf, Issues with S Corporations or Look at that S Car Go. ("S corporations can add zip, but they can also be bulky and slow like a snail.")

7. Bankruptcy Issue; Shareholder Agreement Requiring "Tax Distributions"

A recent bankruptcy case highlights the advantage of having a shareholder agreement that requires the S corporation to make distributions of sufficient cash to shareholders to pay income tax with respect to the flow-through income from the S corporation. In *Zazilli v. Swenson (In re: DBSI, Inc.),* 561 B.R. 97 (2016), the parties conceded that distributions made from a debtor-limited liability company within two years of filing a bankruptcy petition in order to satisfy income tax liabilities of its owner-members were fraudulent transfers that could be reached by the bankruptcy trustee. (The case concluded that such payments made to the Internal Revenue Service were not for reasonably equivalent value, and the IRS was not entitled to retain them.)

8. Converting C Corporation to S Corporation

a. **Advantages.** Advantages of S corporations over C corporations include (i) the possibility for increased cash flow to owners (because the "double tax" on taxable dividends does not apply to S corporations), important especially when owners retire, (ii) increased basis for reinvested earnings, (iii) better tax implications when the S corporation is sold, and (iv) the accumulated earnings tax does not apply to S corporations.

b. **Built-In Gains Tax**. Upon conversion or merger into an S corporation, all assets of the C Corporation must be valued so that the "built-in gains" can be taxed under §1374 if a taxable disposition of the Corporation occurs within five years. (The built-in gains tax originally applied for 10 years, which was subsequently reduced to seven years, and is now permanently five years.) The primary issue is documenting the value of assets as of the date of the conversion or merger.

c. **Tax Year**. Although some limitations apply, S corporations generally must be on the calendar year.

d. **Excess Net Passive Income Concerns**. If the S Corporation has "E&P" (retained earnings and profits from C corporation years) and if passive investment income (such as rents, dividends, royalties, and annuity income) exceeds 25% of gross receipts, the corporation is subject to a tax based on the highest corporate tax rate. §1375. In addition, if that occurs for three years, the S corporation election is revoked in the fourth year. §1362(d)(3). (To avoid that result, the corporation could distribute the E&P or could acquire an active business producing sufficient receipts to satisfy the 25% test.)

9. S Election

All owners must consent to having the entity taxed as an S corporation. This is done by filing Form 2553, which is due the 15th day of the third month after the entity is formed (or after conversion into an S corporation). This is a short timeframe, and planners must be careful to satisfy the election requirement. A trap in community property states is that the owner's spouse that has a community property interest must also sign the form.

The IRS has the authority to treat a late election as timely filed if reasonable cause existed for the late election. Revenue Procedure 2013-30 describes detailed procedures for this relief, providing that the S election can be treated as timely as long as it is filed within three years and 75 days of the date that it is effective if certain detailed procedures and requirements are satisfied.

10. Self-Employment Tax

The self-employment tax is a substantial tax – 15.3% on income up to the taxable wage base [12.4% under §1401(a) and 2.9% under §1401(b)] and 2.9% on all income above the taxable wage base, increasing to 3.8% for taxpayers having self-employment income over $200,000 (single) or $250,000 (married filing jointly) [§1401 (b)].

The flow-through income from partnerships and LLCs, but not S corporations, is subject to the self-employment tax. (However, a limited partner's income is not subject to self-employment tax, except for guaranteed payments for services rendered to a partnership that engages in a trade or business. Also, the Tax Court recently extended the limited partner exception to a passive member of an LLC. *Hardy v. Commissioner*, T.C. Memo. 2017-16, discussed in Gorin, Hardy v. Commissioner: *Tax Court Rules for the First Time that Passive LLC Member is Not Subject to Self-Employment Tax*, LEIMBERG BUSINESS ENTITES NEWSLETTER #158 (March 28, 2017).)

A commonly held misconception is that an S corporation can be used to avoid the self-employment tax. Reasonable compensation (which is subject to the FICA tax) must be paid to employees, however, and the IRS often litigates whether reasonable compensation is being paid to owners of S corporations.

11. Shareholder Agreements

Shareholder agreements for S corporations should include various special provisions including the following:

- Ownership of shares should be restricted so the shares cannot be transferred to an ineligible shareholder; having that provision in the agreement is important (i) to avoid "blackmail" by a shareholder who threatens to transfer shares to an ineligible shareholder, and (ii) for a corporation seeking inadvertent termination relief due to an unauthorized transfer to an ineligible shareholder;
- Each shareholder should give an irrevocable power of attorney to complete the shareholder consent (a power of attorney coupled with an interest can be irrevocable); and
- The agreement may require the corporation to make distributions to shareholders so they can pay their income taxes on flow-through income from the S corporation.

12. Partnerships vs. S Corporations

LLCs and partnerships generally have favorable tax treatment compared to S corporations. Both are flow-through entities, but substantial differences exist. Several of those differences are: (i) the very strict rules on ineligible shareholders do not apply to partnerships; and (ii) a transfer of a partnership interest upon a sale or death allows the buyer or beneficiary to get both a basis step-up on the partnership interest and also an inside basis step-up (if a §754 election is in effect).

13. ESBT Election for Grantor Trust

Only certain types of trusts are eligible shareholders of an S corporation. One is a grantor trust, and another is the trust for which the "electing small business trust" (ESBT) election has been made. (The S corporation income portion of the ESBT will be taxed at the highest individual rate.) A wholly-owned grantor trust can make the ESBT election. The grantor trust rules will have priority over the ESBT election as long as the trust is a grantor trust; but if the trust should fail to be a grantor trust for some reason, the ESBT election would be in effect. Treas. Reg. §1.641(c)-1(a).

Items 14-15 are observations from a seminar by Ronald D. Aucutt, Mickey R. Davis, and Stephanie Loomis-Price, Valuation Issues and the Proposed Section 2704 Regulations.

14. Summary of Proposed Regulations

A summary of the §2704 proposed regulations is available at Item 6 of the Heckerling Musings 2017 and Estate Planning Current Developments (March 2017) found **here** and available at **www.Bessemer.com/Advisor.**

15. Current Status of the §2704 Proposed Regulations

The proposed regulations have spawned a firestorm of responses. Various bills were introduced in 2016 in an attempt to negate the proposed regulations. *E.g*. H.R. 6042 (providing that the proposed regulations "and any substantially similar regulations hereafter promulgated, shall have no force or effect"); H.R. 6100 and S.B. 3436 (blocking funding for completion of the proposed regulations or similar guidance). Rep. Davidson (R-Ohio) and Sen. Rubio (R-Fla.) have reintroduced those bills in the current Congress as H.R. 308 and S. 47.

Statements from the Treasury and the Obama administration to the effect that the proposed regulations "close a tax loophole" that certain taxpayers have used to undervalue assets for estate and gift tax purposes and "that allows some wealthy families to avoid paying their fair share in estate taxes" have fueled a belief that the proposed regulations significantly reduce lack of control and marketability valuation adjustments, producing the firestorm of reactions to the proposed regulations.

In light of having a Republican controlled House and Senate and a Republican President, the likelihood that these regulations will be finalized might seem extremely remote at least as long as a Republican Administration gives direction to Treasury. Especially in light of the firestorm that has erupted over these proposed regulations, a Republican administration seemingly is not likely to finalize these regulations. However, when Treasury Secretary Mnuchin was asked at his confirmation hearing about the §2704 proposed regulations, he did not issue a blanket renunciation of the proposed regulations. He summarized that the goal was to close "appropriate loopholes," but not to eliminate minority interest discounts for interests in operating businesses, perhaps suggesting that the regulations are not dead under a Trump administration:

> Absolutely. I will tell you that both I and the President-elect believe in appropriate regulation. And specifically, on what you've mentioned, on the IRS regs on family businesses, I am committed to working with you and your office—we want to make sure that we cover the appropriate loopholes, so that if people have businesses set up to avoid taxes it's one thing—and they're not real operating business. But any operating business we need to make sure that people who own minority interests in operating businesses that the valuation for tax purposes are reflected appropriately.

Items 16 -21 are observations from a seminar by Stephanie B. Casteel, Professor Christopher R. Hoyt, and Robert K. Kirkland, Charitable Bequests of Retirement Assets: Strategies, Traps, and Solutions.

16. Special Significance of Retirement Assets

Few clients have estate tax issues under current law, but almost all clients have substantial retirement assets. Americans hold approximately $25 trillion of retirement assets as of September, 2016. For many individuals, retirement assets are the largest component of their portfolios. If a client has charitable intent, using retirement assets is often best because the charity will not have to pay estate or income tax upon receiving retirement assets. Furthermore, planning is easy, just requiring a beneficiary designation made payable to the charity.

Unique attributes of retirement assets are that income taxes are due upon receipt of the assets, and in many states they are protected against creditors' claims.

17. Lifetime Charitable Gifts of Retirement Assets

a. **Taxable Distribution**. The only way to access retirement assets for charitable contributions during the participant's life is to receive a distribution and give the proceeds to charity (except for a charitable rollover IRA, discussed below). If an individual is in pay status and receiving minimum distributions, those amounts could be given to charity without any tax disadvantage, because the individual is forced to make a withdrawal of the minimum required distribution amount in any event. If an individual is under age 59 ½, having payments made in a series of periodic payments may avoid the 10% premature withdrawal penalty.

b. **IRA Charitable Rollover**. The IRA charitable rollover provision was made permanent on December 15, 2015. An individual who is at least age 70 ½ can direct that a payment (a "Qualified Charitable Distribution") be made from an IRA to an "eligible charitable organization" of up to $100,000. Such distribution will not be included in the owner's gross income. The Qualified Charitable Distribution can be used to satisfy any required minimum distributions from the IRA for that year. (Bob Kirkland describes this as low hanging fruit for charitable gift officers – "like Tom Brady walking into a room full of deflated footballs.")

18. Charity as Direct Beneficiary at Participant's Death

As a general rule, retirement assets can be paid over the beneficiary's lifetime only if they are paid to a "designated beneficiary," which must be an individual. A charity cannot be a designated beneficiary. Accordingly, if a charity is a beneficiary of a retirement plan, the plan does not have a "designated beneficiary" and all of the plan assets must be paid within five years (including assets payable to individual beneficiaries). However, whether a designated beneficiary exists is determined on September 30 of the year following the year of death (the "beneficiary finalization date"). Therefore, if the charity is cashed out before that date, it is disregarded in determining whether the plan has a designated beneficiary. Reliance on that exception is not recommended because it requires action by the beneficiary before that date, and mistakes happen. A safer approach is to establish two retirement plan accounts, one payable to charity and the other having only individuals as beneficiaries.

19. Charity as Beneficiary of a Trust at Participant's Death

a. **Generally No Designated Beneficiary if Charity is a Trust Beneficiary.** If retirement assets are payable to a trust, all of the trust beneficiaries must be individuals in order for the plan to have a designated beneficiary so that plan benefits could be payable over an individual's lifetime. (For a conduit or accumulation trust, which treats the individual beneficiary rather than the trust as the plan beneficiary, the plan can be treated as having a designated beneficiary as long as all beneficiaries of the conduit or accumulation trust are individuals.)

If a charity is a beneficiary of a trust recipient, the plan will not be deemed to have a designated beneficiary unless the charity is cashed out before the beneficiary finalization date (i.e., September 30 of the following year). Possible planning alternatives are for the trust to distribute assets to the charity other than retirement plan assets (if allowed under the trust instrument) prior to the beneficiary finalization date so that the charity will not be treated as a beneficiary of the retirement plan for purposes of determining if a designated beneficiary exists. Alternatively, the trust could make a distribution of retirement account assets to an individual beneficiary before the beneficiary finalization date. A post-death amendment of the trust to eliminate the charitable interest before the beneficiary finalization date can also work. A blanket provision that retirement benefits may not be distributed to anybody other than individuals will not be effective.

b. **Charity as Recipient of Pecuniary Bequest From Trust**. Various private rulings have pointed out the danger of having retirement assets payable to a trust, which in turn provides pecuniary bequests to charities with the residue being distributed to individuals. *E.g.*, PLR 201438014. (Difficulties include that the charitable pecuniary amount must be satisfied before the beneficiary finalization date, gain may be recognized if it is satisfied with appreciated property, and limitations may exist [as discussed in Item 20 below] in getting a charitable deduction for the trust.)

c. **Possible Exception for Charity as a Remote Trust Beneficiary**. The primary and contingent trust beneficiaries – but not mere potential successor beneficiaries – are taken into consideration in determining whether a designated beneficiary exists when retirement assets are payable to a trust. A 2016 private letter ruling involved a trust payable to a child until age 50, with a provision that if the child died before age 50 the residue would pass to the child's descendants, or if none to the decedent's siblings, or if none to charity. The ruling determined that the charity was a "mere potential successor" beneficiary, and distributions could be paid over the child's life expectancy as a designated beneficiary. PLR 201633025.

d. **Summary**. Avoid using a trust as the beneficiary of retirement assets if trust beneficiaries include both individuals and a charity. Instead, use an attachment to the beneficiary designation which describes a specific dollar amount left to specified charities, with the balance of the retirement plan passing to other individual beneficiaries (such as the "Spencer Share of the Kirkland Family Trust), and fund the charitable portion before the beneficiary finalization date.

20. Fiduciary Income Tax Deduction for Charitable Distributions and Problems With Funding Charitable Pecuniary Bequests in Trusts

a. **General Requirements**. An estate or trust can receive a deduction for distributions to charity only under §642(c) as a charitable deduction, and not as a general distribution deduction. Section 642(c) requires that the payments to charity be made from gross income and that it be made pursuant to the terms of the governing instrument.

An illustration of how harshly these requirements may be applied is Chief Counsel Memorandum 200848020. The trust received taxable income from an IRA distribution but was not entitled to an offsetting charitable income tax deduction because the trust instrument contained no instructions to distribute income to charity.

b. **Direction to Fund Charitable Distribution With IRD**. One possible approach of avoiding that result is to include a provision in every will and trust instrument that if an estate or trust makes a charitable bequest, the payment will be made first with IRD. (Retirement plan assets would be treated as income in respect of a decedent, or IRD.)

A regulation finalized in 2012 states generally that instructions in a trust to distribute specific types of income to charity will not be respected for federal income tax purposes unless the instruction has an "economic effect independent of income tax consequences." Treas. Reg. §1.642(c)-3(b)(2). Professor Hoyt indicates that the independent economic effect requirement under the regulations only addresses the character of income (*e.g.*, interest income, dividend income, etc.) that is distributed to charity, and does not eliminate a charitable income tax deduction under §642(c). It can cause the amount of the charitable income tax deduction to be less than the total amount of the IRD that was transferred to charity, however, if the estate or trust had tax-exempt income, such as interest from municipal bonds.

c. **Funding Pecuniary Trust Distributions**. An estate or trust may recognize gain if a pecuniary bequest is satisfied with appreciated property. Just because the trust recognizes income, however, does not mean that the satisfaction of a pecuniary amount will be treated as a distribution of income pursuant to the terms of the governing instrument in order to entitle the estate or trust to receive a charitable deduction under §642(c). PLR 201438014 denied a charitable deduction to a charitable lead trust that satisfied a pecuniary obligation with appreciated property, because the trust instrument did not "direct or require the trustee to pay the pecuniary legacies from [the] Trust's gross income." *See also* ILM 200644020.

d. **Sample Form Provision**. Prof. Hoyt provides the following sample form clause to address these issues. However, he cautions that such a provision has not appeared in any reported court case or IRS ruling to date.

> **Pay Charitable Bequests with IRD and Other Taxable Gross Income**. Except as otherwise provided in this governing instrument, I instruct my fiduciary that all of my charitable bequests (if any) shall be paid first with taxable income in respect of a decedent (if any), and second with any income generated by making the charitable bequest (if any), so that this trust [or estate] shall be entitled to claim a charitable income tax deduction for such transfer under Section 642(c) of The Internal Revenue Code of 1986, as amended, or under any corresponding section of future income tax laws.

Drafter's comment: This provision is intended to take precedence over any general provision in the governing instrument or under state law (including the Uniform Principal and Income Act), such as the traditional policy that capital gains are to be retained by a trust or an estate rather than distributed to the beneficiary. If, however, there is a specific conflicting provision in the governing instrument, then such conflicting provision will control over this provision. Common examples of conflicting provisions include instructions that:

*retirement plan distributions that are received by a trust may only be paid to "designated beneficiaries" after a specified date (such as September 30 following the year of death),

*all of a trust's [or estate's] income in respect of the decedent shall be paid to a single charity, and

*income shall be allocated to a surviving spouse in such a manner that a trust or estate may claim a marital estate tax deduction on a federal estate tax return.

Prof. Hoyt also points out the practical advantage of not commingling IRD proceeds with other cash receipts (*i.e.*, deposit the IRD proceeds in a separate checking account that only receives IRD proceeds) to strengthen the argument that the fiduciary is carrying out the instructions in the governing instrument and is in fact distributing the IRD to charity.

21. Possble Legislation Eliminating Stretch IRAs

Various legislative proposals since 2012 would eliminate the stretch IRA and require that retirement plan assets be distributed within five years following the owner's death (with certain exceptions for a spouse, minor children, or a disabled beneficiary). That provision was included in the Obama administration's 2015 and 2016 fiscal year budget proposals, and was included in a bill approved unanimously (suggesting bipartisan approval of the approach) by the Senate Finance Committee in September 2016. This provision has a good chance of being adopted.

If so, an even greater incentive to use retirement plan assets for benefiting charity will exist (because the income tax liability associated with the retirement plan asset will have to be paid within five years even if the retirement assets passed to individuals). In addition, funding a charitable remainder trust with an IRA may present some deferral opportunities, because the trust would be exempt from income tax, but the income will be "leaked out" to beneficiaries as payments are made to individual beneficiaries over the term of the charitable remainder trust.

Items 22-32 are observations from a seminar by Charles E. Hodges II and Jenny L. Johnson, Estate and Gift Tax Audits: Practice Tips from a Trial Lawyer's Perspective.

22. Changes in IRS Staffing and Audits

The IRS staff has been cut by 20% since 2010, with 13,000 fewer employees. The enforcement personnel that handle audits and litigate cases have been reduced by 25%. The IRS now has the lowest audit rate in a decade. IRS representatives who handle audits are generally very well experienced. Because there are fewer of them, they tend to "look for the home run." Therefore, try to minimize audit exposure as much as possible.

23. Conflicts of Interest Issues

Various family members may have different objectives in an examination. Some want resolution as soon as possible, others want to pay as little as possible, others may be concerned about undisclosed gifts, etc. An increasing number of audits have occurred at the death of the first spouse, which often can lead to conflicts of interest in estate tax examinations of those estates.

Circular 230 §10.29 addresses conflicts of interest in representing clients before the IRS. It provides that a conflict of interest exists if the representation is directly adverse to another client or a significant risk exists that the representation will be materially limited by responsibilities to another client, a former client, or by "a personal interest of the practitioner" (for example, if the planner has used similar planning for other clients). If a conflict exists, the practitioner must reasonably believe that competent representation can still be provided, and each affected client must waive the conflict of interest and give written informed consent. Circular 230, §10.29(b).

U.S. Tax Court Rule 24 and ABA Model Rules of Professional Conduct Rules 1.7, 1.8, and 3.7 also address conflicts of interest.

24. Attorney-Client Privilege

a. **General Description**. The attorney-client privilege applies to confidential communications between an attorney and client for the purpose of facilitating the rendering of legal advice (not business advice or accounting advice). The privilege does not exist as to communications with non-client family members or other third parties (unless the communication is to assist the attorney in rendering legal advice). The privilege also does not apply as to underlying facts, bills and invoices, or the preparation of tax returns or return preparation materials (including information relating to appraisals attached to returns).

b. **Kovel Letters**. The privilege may apply as to an outside person that has helpful information to assist the attorney representing the client if the person has a particular skill the attorney does not have. The attorney should send the individual a "Kovel letter" engaging the person to assist the attorney. The privilege as to communications with a third person is not foolproof; for example, if the attorney is having a hard-core conversation with the client about potential fraud, the third person should not be present.

   One of the speakers uses a very broad Koval letter, providing that everything the individual does and all of the individual's workpapers belong to the lawyer. That provision protects the client and the third person. The best practice is for the attorney actually to keep the workpapers so they are not in the other party's files at all. For example, if a CPA is assisting the attorney and the CPA receives a subpoena to produce all items in the CPA's possession related to the matter, the workpapers would not be produced.

   Some believe that the lawyer must pay the third-party, but panelists believe that the client has the responsibility of paying the third-party, even though the third party is engaged by the attorney.

b. **Unintentional Waiver.** The attorney should carefully consider whether other participants (such as family members) should be included in conferences. The presence in a conference of family members who are not clients likely means that the communications would not be privileged. A letter summarizing legal advice that is shared with a banker or other person who referred the client to the attorney would not be privileged.

In the Tax Court, the party asserting privilege has the burden to prove that it has not been waived. An inadvertent waiver may be imputed to the client.

c. **Document Production**. The attorney should perform a very careful privilege review before producing documents to the IRS.

d. **Return Preparation**. Activities involved in preparing returns (including workpapers for the preparation of returns) are not covered by the privilege. If the attorney is preparing returns, the attorney should maintain separate return preparation files and planning files. CPAs should follow the same practice of maintaining separate return preparation files and tax advisor files.

e. **Work Product Protection**. Work product is different than the attorney-client privilege. Work product is a protection (to protect the attorney's ideas), not a privilege. Judges can order the production of work product only in limited circumstances. The work product protection applies only to materials prepared in reasonable anticipation of litigation. The anticipation of litigation must be reasonable and the protected information must be connected to the anticipated litigation.

As a practical matter, the best way to protect documents is to write "Attorney Work Product-Protected" on the top of all memos and other protected materials, and to document the reasons that litigation may be anticipated at that time.

Information prepared in the course of completing a transaction may conceivably be covered by the work-product privilege. One of the panelists reported personal experience in a case in which the court concluded that the planning attorney's written notes constituted clear communication intended to inform the client of complexities that could lead to legal exposure because of the aggressive nature of the transaction, and the purpose was to aid in future litigation.

A waiver by a client of the attorney-client privilege does not waive the work product protection available to the attorney.

f. **Practical Limits on Attorney-Client Privilege in Tax Matters**. If the IRS asserts penalties in an examination, the taxpayer's first defense is that the taxpayer reasonably relied upon a tax advisor. The client may have to waive the attorney-client privilege to produce documents relating to the advice on which the client relied. Therefore, all communications with the client would have to be produced. That would not prevent the attorney from claiming the work-product protection for materials covered by the work product doctrine.

25. Fifth Amendment Privilege

A client may also assert the Fifth Amendment privilege against self-incrimination. Doing so, however, may create an adverse inference that can be considered in civil litigation, and may increase the likelihood of a criminal action. (Before invoking this privilege, consult a criminal tax attorney.)

26. Thinking Proactively About Risk

a. **Disclosure on Gift Tax Return**. One of the panelists is a big proponent of disclosing transactions on gift tax returns to start the statute of limitations. Other lawyers may approach the gift tax disclosure issue very differently.

b. **Tax Opinions**. A tax opinion may have to be produced at some point as a defense against penalties. Be careful in what is written in memos and opinions that may eventually have to be turned over to the IRS.

c. **Potential Risks**. Think proactively ahead of time about potential risk issues and potential defenses. For example, something may be produced to the IRS that may satsify the agent a forestall a deeper dig by the agent. The attorney should dig first and determine the worst things that might surface and what the potential exposure would be. How can the audit be handled in a way that can avoid the thorniest issues? Will a deeper dig by the agent potentially uncover conduct that could expose the client to criminal liability, significant civil liability, or personal strife? Quantify potential penalties and interest. Assess the likelihood that uncertain items will be discovered.

d. **Appeals Coordinated Issues**. The IRS has identified certain issues that are "appeals coordinated issues" that automatically are reviewed under parameters established by the national office.

e. **Criminal Risk Audits**. "Eggshell audits" are those in which a thin eggshell exists between the civil exam getting turned into criminal litigation. The attorney should carefully investigate facts and assess if potential criminal exposure exists. The attorney must practice the art of fulfilling professional and ethical obligations while minimizing the client's exposure. For example, if a significant potential of criminal exposure exists, do not just keep turning over documents that may support the criminal claims.

27. Responding to Information Document Requests

a. **No Requirement to Respond Unless Summons is Issued**. No law requires a client to respond to an IRS information document request, but if the taxpayer does not cooperate, the IRS can issue a summons that can be enforced by a court.

b. **Position Statement**. Once the attorney responds with the taxpayer's position regarding an issue, the client is stuck with that position.

c. **Not Required to Prepare Documents**. A taxpayer merely needs to produce documents that are within the taxpayer's possession or control. A taxpayer cannot be required to prepare a spreadsheet or prepare another document requested by the IRS. However, sometimes the client's best interest will be served by creating a document and walking the examiner through it. For example, the document may summarize a nice chronology of events, a helpful summary of the transaction, etc. If the taxpayer's best interest is served by doing the IRS's work for them, then do it. This is a judgment call of what will get the IRS out of the client's hair as soon as possible. Making the agent's job easier can assist in settling the case. An important factor in every audit is to teach the auditor and get the auditor to trust the attorney.

d. **Shifting Burden of Proof.** Under §7491, the taxpayer's initial burden of proof can be shifted to the IRS if the taxpayer complies with requirements to substantiate any item and cooperates with reasonable requests for witnesses, information, documents, meetings, and interviews. In order to prove that the taxpayer has reasonably complied with information requests, careful records of all responses to information requests and documents produced should be retained. Being able to show that the IRS will have the burden of proof in tax litigation assists in settling cases.

28. Extension of Statute of Limitations

The estate tax period of assessment cannot be extended, but the period of assessment for gift or income tax returns can be extended by the taxpayer. The planner should carefully consider whether signing a waiver is merely giving the agent more time to assemble information that can be used against the taxpayer. However, if the planner believes that the auditor is just confused and that the confusion can be cleared up, perhaps an extension would be warranted. Particularly for new issues or cases that the IRS does not know how to litigate well, one panelist will not sign an extension, believing that an extension will allow the IRS to try other cases and figure out better strategies.

29. Ethical Duties With IRS and Interviews With Client

A tension may exist between the duty to provide accurate information (Circular 230 §10.22) versus the duty of confidentiality with the client. The attorney cannot give the IRS anything that is not true.

What if the IRS asks about information that the client is not willing to share with the IRS? The attorney cannot lie to the IRS and also cannot disclose confidential information that the client will not authorize. At that point, the attorney may have to withdraw from the representation. For example, the attorney may explain to the client "we can go back in the room and correct that statement, or I can't be your lawyer anymore."

The IRS likes to get early taxpayer interviews that are recorded, but avoid client interviews with the IRS. If the IRS requests a meeting with the taxpayer, the lawyer should explain that the lawyer has a right to represent the taxpayer. The lawyer should request an opportunity to answer questions, obtain documents, etc. "If I'm not able to give you the information, then we can talk about an interview." One panelist indicated that that attorney has never been in an audit in which the client was interviewed by the IRS. That has never become a confrontational issue, but the attorney was able to navigate around the request. The IRS cannot force a taxpayer interview unless it issues a summons that is enforced by a court.

30. Dealing With Experts

a. **Appropriate Expertise**. First and foremost, consider if the expert really has expert knowledge about the particular matter at issue.

b. **Engagement Letter**. The letter engaging the expert will ultimately be turned over to the IRS. (The attorney's engagement letter may also be produced.)

c. **Drafts**. In the past, prior drafts of experts' reports had to be produced. Under Tax Court Rule 70(c)(3) and Federal Rules of Civil Procedure 26(b)(3), draft reports and attorney-expert communications are now generally privileged. To protect the privilege, the attorney should engage the appraiser, and the attorney should serve as an intermediary for communication.

31. Requesting Information from IRS

Section 7517 allows taxpayers to obtain copies of any documents the IRS relies on with respect to the determination or proposed determination of value for estate, gift or GST tax purposes. The IRS must respond to a written request within 45 days after the later of the date of the request or the date of determination or proposed determination of value. Obtaining information in this manner is much faster than Freedom of Information Act requests. For example, this may allow obtaining a copy of the IRS valuation engineer's report.

32. Alternatives When Agreement Cannot Be Reached With Examiner

a. **Appeals**. The Appeals Division is independent of any other IRS office and serves as an informal administrative forum for any taxpayer who disagrees with an IRS determination. *Ex parte* communications are not permitted between Appeals personnel and other IRS personnel to the extent the communications appear to compromise the independence of the Appeals personnel.

The most effective approach may be to write the appeals case report for the appeals officer, and give the report to the officer in a Word document. The report puts the facts in the best light possible. That approach makes it as easy as possible for the appeals officer to decide in the taxpayer's favor.

The allocation of cases among appeals officers is now designed to get cases to the officer with subject matter expertise for the issues involved.

b. **Alternatives.** A taxpayer's alternatives upon receiving a Notice of Deficiency are:

- Pay the tax;
- File a petition in the Tax Court for redetermination of the deficiency, and do not pay the tax;
- File a petition in the Tax Court for redetermination of the deficiency and deposit the tax to stop interest from accruing; or
- Pay the tax due shown on the Notice of Deficiency, file a refund claim with the IRS, and after the IRS does not respond within the six months that it has to respond, file suit for refund in the US District Court, or Court of Federal Claims.

c. **Choice-of-Forum Decision Factors**.

Upfront Payment of Tax. If the taxpayer wants to avoid paying taxes upfront, the Tax Court must be used.

Who Decides. A judge rather than a jury decides the case in the Tax Court and Court of Claims. In the District Court, a jury is available. The judge in either a District Court or Court of Claims case will not be a tax expert.

Issues Involved. If the taxpayer has the better technical tax argument, choose the Tax Court; if not choose the District Court or Federal Court of Federal Claims.

Evidentiary Rules. The evidentiary rules in the Tax Court are more cost-effective. Limited discovery is allowed; depositions are rare except in very large cases. A detailed stipulation process makes trials much shorter.

Government Attorney. The IRS Chief Council office litigates in the Tax Court, but the Department of Justice litigates in the District Court or Court of Claims. Attorneys with the IRS Chief Council office typically do not have as much trial experience as the Department of Justice attorneys.

Burden of Proof. In the Tax Court, the taxpayer has the burden of proof unless it is shifted to the IRS under §7491. In the District Court and Court of Claims, the taxpayer must prove the actual amount that is correct. (Throwing darts at the IRS's valuation approach is easier than actually having to prove the right number.)

Location. The Tax Court conducts trials in a wide variety of locations, and the taxpayer can pretty much decide where the case will be heard. In the District Court, the trial will be where taxpayer resides. In the Court of Claims, the trial will usually be conducted in Washington D.C.

Settlement. Settling with the Department of Justice is sometimes easier, because the attorneys will consider trial risk. Disagreeing with the position of the IRS may be easier than for a IRS Chief Counsel attorney. One of the panelists believes that is a very important factor.

Tax Court Petitions. The Tax Court hears 95% of tax litigation. Of the 15,000 cases filed each year, only about 3% are tried; most are settled. The taxpayer should not be scared to disagree with the examiner and appeals officer. The attorney who is going to have to stand before the judge trying the case may be more amenable to settlement.

Items 33-38 are observations from a Seminar by Gail Cohen and Read Moore, Do You See What I See? Tax Transparency and the Common Reporting Standard

33. Background Behind Creation of Common Reporting Standard

a. **FATCA**. The Foreign Account Tax Compliance Act (FATCA) was enacted by Congress in 2010 to target tax evasion by U.S. taxpayers using foreign accounts. FATCA requires foreign financial institutions (FFIs) to report to the IRS information about financial accounts held by U.S. taxpayers, or by foreign entities in which US taxpayers hold a substantial ownership interest. FATCA generally requires the FFI to conduct due diligence, to determine if the account owners are U.S. citizens, and to report information about accounts owned by U.S. citizens to the United States. When FATCA was first enacted, other countries were outraged that the U.S. was unilaterally requiring banks in their country to divulge information about U.S. account holders. Eventually, the other countries decided that was a good idea and ultimately developed the Common Reporting Standard (CRS) system as a way of exchanging information with other countries about financial information of owners connected with those other countries.

b. **Introduction to CRS**. CRS began in 2012 as a pilot initiative of five European countries to follow the FATCA model as a multilateral reporting tool on beneficial ownership. In 2014, the system was adopted by the Organisation for Economic Cooperation and Development (OECD) with a model treaty and Multilateral Competent Authority Agreement. CRS has now been adopted by over 100 jurisdictions. Of those, 54 will be reporting in 2017 (for activities in 2016), and the remainder will start reporting in 2018 (for activities in 2017).

The participating countries agree under a "common reporting standard" to share information automatically about assets and income in one country of persons having connection with another participating jurisdiction. Each jurisdiction can adopt rules about what accounts are reportable to that jurisdiction (while the U.S. has a taxation system based on U.S. citizenship or residence, most countries use a variety of other standards (such as nationality) to determine the basis for taxing persons or entities). For "reportable accounts" the information required to be shared includes 1) the name, address, tax identification number and date and place of birth of each reportable person, 2) the account number, 3) the name and identifying number of the Reporting Financial Institution, 4) all types of investment income, and 4) the account balance or value and sales proceeds as of the end of the relevant period.

Financial institutions required to report under CRS include not only banks but also other financial institutions such as brokers and certain investment vehicles.

Reportable accounts include accounts held by individuals and entities (including trusts and foundations) and the standard includes a requirement to look through passive entities to report on the individuals that ultimately control the entities.

The details about the common reporting standard are quite lengthy – hundreds of pages long. The information and reporting requirements under CRS are significantly broader than under the FATCA model.

The United States has not committed to the Multilateral Competent Authority Agreement. (Because of FATCA, the U.S. does not feel a need to be part of the information sharing system of CRS.)

A few jurisdictions (Bahamas, Hong Kong, Singapore, and Switzerland) are adopting this approach on a bilateral basis in which they pick the jurisdictions with which they agree to share information. While most countries have agreed with the multilateral approach (which avoids the necessity of multiple treaties with many different countries), the mechanics of sharing information is developing on a country-by-country basis. The Multilateral Competent Authority Agreement requires each participating country to adopt domestic legislation in the country, and the details regarding the manner in which information is shared varies from country to country.

Challenges with this multilateral approach include that (1) legislation in each of the jurisdictions is different, (2) interpretation of the enabling legislation will be different, and (3) some concepts (such as trusts) are not recognized in all of the participating jurisdictions. Tension arises in the attempt to develop a worldwide common standard for reporting that applies to concepts (such as trusts) that are not common in all of the participating jurisdictions.

34. Financial Institution

Similar to FATCA, the reporting is required by foreign financial institutions. Financial institutions include mainly banks and trust companies but also certain investment entities.

If an account is opened by another financial institution, the reporting is minimal, because that financial institution owner is required to report directly under CRS. If a foreign entity owning an account is not a financial institution, detailed reporting is required. (They are subject to particular scrutiny under the feeling that they comprise a significant portion of tax cheaters.)

A key fact in completing forms to open a foreign account is whether the owner is a financial institution. The financial institution where the amount is being opened will be subject to a much higher level of due diligence in obtaining and reporting information about foreign entities that are not financial institutions.

35. Differences Between FATCA and CRS

Some of the differences between FATCA and CRS include the following:

- FATCA (but not CRS) requires financial institutions to have a global intermediary identification number (GIIN);
- FATCA refers to foreign financial institutions (FFI) and CRS refers to reporting financial institutions (RFI);
- FATCA includes a 30% withholding penalty for noncompliance while CRS is on the honor system (but many jurisdictions have created their own regulatory penalties);
- Under FATCA, a W-8 BEN-E form is used when opening accounts, and it is a complicated form including 28 different potential statuses for the owner opening the account; a uniform form is not used under CRS but some countries have developed their own standard forms;
- The focus under CRS is on obtaining tax information numbers rather than focusing on citizenship; and
- CRS requires reporting significantly more information about the controlling persons of entities, ultimately including the individuals who are the beneficial owners and controlling persons for the account; institutions are required to look through shell companies, trusts or similar arrangements to determine the *individuals* for whom information must be reported.

36. Trusts

Trusts are viewed very skeptically by most countries in the world as vehicles for tax evasion. Institutions are required to obtain information about the controlling persons of accounts, which for trusts includes individuals connected in any way to the trust – such as trustees, trust protectors, anyone who can remove and replace the trustee, and any beneficiary who may receive mandatory or discretionary distributions from the trust.

37. Significance for Estate Planning Attorneys

Many ultra-high net worth families will have some non-U.S. connections of assets or family members.

U.S. clients (especially entity-clients such as companies or trusts) opening a foreign financial account will be presented with three forms to be signed: (1) W-9 (to satisfy the FATCA requirement), (2) a U.K. FATCA form, and (3) a CRS form used in that particular jurisdiction.

Any U.S. entity that opens an account outside the United States will fall in the category of being a non-financial institution, which will require a significantly higher degree of due diligence by the institution in opening the account. The institution must include information about all beneficial owners, which includes owners in control of the entity. For a trust this includes trustees, protectors, persons who can remove and replace the trustee, and any beneficiary.

38. Customer Due Diligence Requirements Beginning in 2018

FinCEN (the U.S. Department of the Treasury Financial Crimes and Enforcement Network) published Customer Due Diligence Requirements for Financial Institutions on May 11, 2016, implementing more stringent customer due diligence requirements and giving financial institutions until May 11, 2018 to comply with the new requirements. New accounts opened after that date will be subject to these new due diligence requirements. For trusts, the financial institution must verify and obtain information about the trustee, settlor, protector, or anyone with control over the trust (but NOT the trust beneficiaries). Information that must be collected includes the name, date of birth, address, and Social Security number or other government identification number for individuals owning more than 25% of the equity interest of a legal entity, or that have control rights over trusts.

Items 39-43 are observations from a seminar by Bruce Stone, Jonathan D. Blattmachr, BethAnn Chapman, and Alvin J. Golden, Community Property in Common Law States: Stranger in a Strange Land?

39. What is Community Property?

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

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

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

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

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

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

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

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

   In common law states, the presumption is that property titled in one spouse's name belongs to that spouse (see subparagraph h below).

   These default presumptions often end up being the deciding factor when uncertainty exists about whether property is community property or in a common law state if it is owned entirely by one spouse or jointly by both spouses.

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

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

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

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

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

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

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

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

a. **Property Rights.**

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

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

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

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

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

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

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

d. **Tax Effects.**

Income Tax. Each spouse owns one-half of the income for income tax purposes, so income splitting exists 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, little (if any) property is 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.

41. Elective Community Property Systems (Alaska, Tennessee, and South Dakota)

a. **Overview.** Alaska in 1998 (modeled on the Uniform Marital Property Act), Tennessee in 2010, and South Dakota is 2016 passed legislation allowing spouses by agreement or trust in Alaska or by contributing property to a trust in Tennessee or South Dakota to elect into community property systems (in Alaska or Tennessee) or to establish a "special spousal trust" (in South Dakota). (The South Dakota statute states that "special spousal property" means community property under the "community property laws of South Dakota" for purposes of §1014(b)(6). S.D. Codified Laws §55-17-5.)

Under the Alaska, South Dakota, 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, South Dakota, and Tennessee law. In Alaska, residents of the state can also elect community property by agreement, with detailed default provisions regarding the scope or the community property election, the ability to create survivorship community property, and community property treatment.

The South Dakota legislation refers to the creation of a trust declaring that some or all of the property transferred to the trust is special spousal property, and the legislation describes the nature of special spousal property that is similar to community property systems.

The three states require a trustee to be either domiciled or doing business in the state and have certain minimum powers.

The Alaska and South Dakota acts specifically provide that community property contributed to the trust remains community property.

In Tennessee, when property is distributed from the community property trust, it is no longer community property, but the Alaska legislation provides that property distributed from the community property trust remains 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.

b. **Recognition as Community Property Under §1014(b)(6).** Section 1014(b)(6) allows a basis adjustment for both halves of community property upon the death of either spouse if at least 50% of the property is included in the decedent's gross estate for federal estate tax purposes. The community property characterization of assets under the Alaska, Tennessee, or South Dakota laws will probably also be recognized under §1014(b)(6). The following reasons support this conclusion (but the IRS has not confirmed that §1014(b)(6) applies).

- The property rights have the general basic characteristics of community property, including that (i) each spouse owns a 50% interest [but the South Dakota act does not make that explicit], (ii) spouses have responsibilities to each other regarding the property, and (iii) management and control rights are specified (with default rules if the rights are not modified). (See *Angerhofer v. Commissioner*, 87 T.C. 814 (1986) for a discussion of community property rights that need to be present for the assets to be respected as community property for U.S. tax purposes.)
- Section 1014(b)(6) refers to the law of "any state" (rather than just referring to the law of the state of domicile).
- IRS Publication No. 555, "Community Property" (revised February 2016) states that the Publication does not address the taxation of "income or property subject to the 'community property' election under Alaska state laws." IRS Manual 25.18 states that the classification of property under the Alaska Act should be governed by the U.S. Supreme Court decision in Commissioner v. *Harmon*, 323 U.S. 44 (1944) "for income tax reporting purposes." (The *Harmon* decision held that one-half of the income earned by one spouse that was classified as community property under the short-lived Oklahoma community property opt-in system could not be reported on separate tax returns by the non-titled spouse. *See also* Rev. Rul. 77-359.) The Manual does not address whether the IRS would extend the *Harmon* decision to deny §1014(b)(6) basis adjustment to elective community property.
- Informal surveys of attorneys do not reflect any situations in which the IRS has contested the application of §1014(b)(6) to community property created under the elective systems of Alaska, Tennessee, or South Dakota. One speaker filed an estate tax return for an Alaska decedent who elected for the assets to be community property, and the assets were reported as community property. An IRS examiner from Seattle asked if the assets were in fact community property in light of the *Harmon* decision. The panelist wrote a letter to the IRS giving reasons why the assets were community property despite *Harmon* (no income splitting was involved, the spouses filed joint returns, each spouse could dispose of one-half of the assets at death, the spouses had joint management rights of the assets, etc.), and the estate received a closing letter with no further inquiry.

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

a. **Uncertainty.** If a couple acquires assets as community property in a community property state and later moves to a common law state, the answer is not absolutely clear as to whether the assets (particularly real property purchased in the new state with community funds) remain as community property. (Al Golden quipped at one point: "There are not absolute answers. Even though I think Jonathan is wrong, I can't prove it.") "General rules" are summarized below, but keep in mind that uncertainty exists. (The idea for this seminar arose, in part, as a result of a debate on the ACTEC listserv and at committee meetings as to whether property remains as "community property" for purposes of the §1014(b)(6) basis adjustment for community property if spouses move from a community property state to a common law state.)

b. **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 that 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.

The Restatement (Second) of Conflicts of Laws §§258-259 address this issue with respect to movables. Section 258 states the general rule for movables that typically the law of the state having the most significant contacts governs the ownership of property, and further the law of the marital domicile be that same state, absent a contrary choice of law bv the spouses. Section 259 discusses the impact of a move of the property or of the marital domicile:

> A marital property interest in a chattel, or right embodied in a document, which has been acquired by either or both of the spouses, is not affected by the mere removal of the chattel or document to a second state, **whether or not this removal is accompanied by a change of domicil [sic] to the other state** on the part of one or both of the spouses. The interest, however, may be affected by dealings with the chattel in the second state. (Emphasis added.)

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. *See generally* Thomas Oldham, *What if the Beckhams Move to L.A. and Divorce? Marital Property Rights of Mobile Spouses When They Divorce in the U.S.*, 39 BAYLOR L.REV. 1255; George Mills, *Conflict of Laws: Property Acquired After Marriage*, 35 LA. L.REV. (Fall 1974).

An example case is *Quintana v. Ordono*, 195 S. 2d 566 (Fla. Dist. Ct. App. 1967, in which spouses acquired significant assets as community (though title was solely in the husband's name) while domiciled in Cuba and subsequently moved to Florida. The husband died intestate, and the issue was whether the wife owned one-half of the assets as her interest in community property. The decedent's children argued that the assets were titled in his name and were his assets. The appeals court reversed the trial court, holding that at least as to movables, the assets were community property and the move to Florida did not change the spouses' rights: "The interest which vested in the wife was not affected by the subsequent change of domicile to Florida."

An old Tax Court case that recognized this general approach for tax purposes is *Johnson v. Commissioner*, 88 F.2d 952 (8th Cir. 1937). After acquiring community property in Texas, the spouses moved to Missouri and reported half of the income from property that was acquired as a mutation of the Texas property on wife's separate income tax return (joint returns were not permitted at that time). The IRS maintained that all of the income (while living in Missouri) should be reported on the husband's income tax return. The court concluded that half of the income that could be traced to the community property should be reported on the wife's return, but on remand, the parties were not able to satisfy the tracing requirements. The court of appeals case noted:

> It is also conceded by the Commissioner that the taxpayer's wife did not lose her rights in the community property when she and the petitioner removed from Texas to Missouri, where the community property law is not in force. *Depas v. Mayoi,* 11 Mo. 314, 49 A,.Dec. 88; *Edwards v. Edwards,* 108 Okl. 93, 233 P. 477.

One panelist believes that the assets do not remain as "community property" after the couple moves to a common law state even if the spouses are treated as each owning one-half of the assets, and that the §1014(b)(6) adjustment for community property should not apply to those assets. He argues, for example, that the *Quitana* case does not say that the property remains community property, but just that the wife's vested rights did not change.

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

c. **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, Connecticut, Florida, Hawaii, Kentucky, Michigan, Minnesota, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming). The UDCPRDA generally provides that imported property that was originally community property remains community property for purposes of testamentary dispositions—meaning that a deceased spouse can dispose of one-half such property. Any property held by a married couple as tenants by the entirety or by another form of joint ownership with right of survivorship is presumed not to be community property, even if the community property state where 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. No federal income tax authority exists 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.

d. **Effect for Divorce Purposes.**

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

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

e. **Effect for Death Purposes.**

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

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

43. Planning Strategies for Migrating Clients

For as discussion of planning considerations for representing couples who have (or may have) moved into or from a community property jurisdiction, see Item 4 of the ACTEC 2013 Fall Meeting Musings found **here** and available at **www.Bessemer.com/Advisor**.

Items 44-51 are observations from a seminar by Katarinna McBride, James D. Spratt, Jr., and Michael Stegman, The Battle Over Trusts in Divorce—Invasion and Surrender

44. Overview of Significance of Divorce Planning Considerations in Estate Planning Context

a. **Changed Paradigm from Traditional Planning.** Estate planning attorneys typically spend more time discussing protecting beneficiaries from creditors generally than planning for protection from a beneficiary's spouse in a divorce action. That is ironic because relatively few beneficiaries have experienced creditor attacks on their trusts, but divorce actions are common. Planners should spend more time discussing how to protect beneficiaries from divorce claims. Traditional trust drafting often does not do that. Planners often focus on maximizing control, flexibility and tax savings for the beneficiary. Those provisions may hurt with respect to protecting trust assets against divorce claims. The more control/interest the beneficiary has in the trust, the more likely it will be treated as marital property or will be considered in determining how property that does constitute marital property is divided or in setting alimony.

   Strings that may be allowed without causing estate inclusion for a beneficiary can lead to problems in protecting the trust assets if the beneficiary divorces. Good family lawyers pride themselves in being creative when arguing fairness in a court of equity, with many tools at their disposal to convince the judge to do what he or she thinks is fair.

b. **Trusts – Trend Toward Longer and More Discretionary Trusts.** Several decades ago, many trust instruments tended to terminate at ages 25, 30 and 35 for beneficiaries. Later, a trend developed to leave assets in trust but allowing the children to withdraw assets after reaching certain ages. An emerging trend is to suggest distributions that might be made at certain ages, but provide that distributions are totally discretionary with the trustee. Long-term sprinkling dynasty trusts, perhaps with totally discretionary distributions, are becoming more normal. This trend reflects, in part, an increasing concern with "predator protection," including attacks on a trust by a beneficiary's spouse in a divorce proceeding.

c. **Third Party Trusts and Trusts Created by Divorcing Spouses**. Issues can arise both with respect to (i) trusts created by third parties in which a divorcing spouse is a beneficiary, and (ii) trusts created by one or both of the divorcing spouses for which changes may be desirable after the divorce is finalized.

45. Traditional Spendthrift Principles

a. **Overview.** Under traditional trust law principles, trust assets will be more protected from claims of creditors of beneficiaries if the trust is a pure discretionary trust (rather than having ascertainable standards for distributions) and if the beneficiary is not the trustee (at least with a discretionary trust). In addition, spendthrift provisions provide protection against a beneficiary's creditors, but many states have adopted "exception creditors" including claims for child support and alimony that may reach trust assets despite the spendthrift provision.

b. **UTC – Spendthrift Clause**. Under the Uniform Trust Code, a spendthrift clause protects against a beneficiary's general creditors (§502(c)), but does not protect against exception creditors (including a spouse, child, a former spouse who has a judgment against the beneficiary for support or maintenance and certain others) (§503(b)). Exception creditors may obtain a court order attaching present or future distributions to or for the benefit of the beneficiary, which the court may limit as appropriate under the circumstances. §503(c). For support trusts (with a standard for distributions that is *not discretionary*), a creditor apparently can seek to have a court compel the trustee to make a distribution under the distribution standard. *Cf.* §504(b) (trustee of *discretionary* trusts generally cannot be compelled to make distributions, whether or not a spendthrift clause applies).

c. **UTC – Discretionary Trusts**. The Uniform Trust Code also provides protection to discretionary trusts even in the absence of a spendthrift clause. §504(b). Furthermore, discretionary trusts protect against even exception creditors unless an abuse of discretion has occurred. §504(c). Discretionary trusts are trusts that give the trustee discretion in whether to make distributions, whether or not a distribution standard exists (such as for health, education, support, or maintenance) and whether or not the language of discretion is combined with language of direction (such as "shall, in the trustee's absolute discretion, distribute such amounts as are necessary for …"). *See* §506(a). For a trust with a standard of distribution that is also subject to the trustee's discretion, the trustee generally cannot be compelled to make distributions whether or not a spendthrift clause is present (even if the trustee has abused the discretion), but the trustee can be compelled to make distributions under the standard to satisfy a judgment for support or maintenance of the beneficiary's child, spouse, or former spouse (even if the trust has a spendthrift clause). §504(c). In any event, if a trustee voluntarily makes a distribution to a beneficiary, the assets can be reached by the beneficiary's creditors. §502 Comment.

d. **UTC Provisions**.

§ 501. If a beneficiary's interest in a trust is not subject to a spendthrift provision, a court may authorize a creditor or the assignees of the beneficiary to reach the beneficiary's interest in the trust by attachment of present or future distributions for the benefit of the beneficiary.

§ 502(c). When a trust includes a valid spendthrift provision, a beneficiary may not transfer his interest in the trust and a creditor or assignees of the beneficiary may not reach any interest or distribution from the trust until the beneficiary receives the interest. A Comment to §502 states that unless one of the exceptions applies (as discussed below) a creditor of the beneficiary is prohibited from attaching a protected interest and may only attempt to collect directly from the beneficiary after payment is made from the trust.

§503 — Spouse, Former Spouse or Child as Exception Creditors. Section 503 provides various exception creditors who can reach interests in spendthrift trusts. Section 503(b) provides that "[a] spendthrift provision is unenforceable against: (1) a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance …" Section 503(a) defines a "child" as including "any person for whom an order or judgment for child support has been entered in this or another State.) Section 503(c) states that even if the trust contains a spendthrift provision, exception creditors "may obtain from a court an order attaching present or future distribution to or for the benefit of the beneficiary." That is very strong authorization for attaching present or future distributions from the trust. The Comments to §503 state that "[t]he exception for judgments or orders to support a beneficiary's child or current or former spouse is in accord with Restatement (Third) of Trusts… and numerous state statutes. It is also consistent with federal bankruptcy law, which exempts such support orders from discharge."

§504 — Discretionary Trusts. Section 504(b) provides that other than as provided in §504 (c) (discussed immediately below) whether or not a trust has a spendthrift provision, a creditor of the beneficiary may not compel a distribution that is subject to the trustee's discretion even if the discretion is expressed in the form of a standard or the trustee has abused the discretion. Section 504(c) contains an exception dealing with a beneficiary's child, spouse, or former spouse. It provides:

> "To the extent a trustee has not complied with a standard of distribution or has abused a discretion:
>
> (1) a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child, spouse, or former spouse; and
>
> (2) the court shall direct the trustee to pay to the child, spouse, or former spouse such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion."

Strong Provisions. These UTC provisions provide strong protection for children, spouses, or former spouses of beneficiaries, even despite the existence of spendthrift provisions in the trust.

e. **Non UTC States**. In non-UTC states, a "pure" discretionary trust permits distributions under a trustee's "sole," "uncontrolled," or otherwise unlimited exercise of discretion, and does not include a governing standard for trust distributions. H.S. SHAPO, G.G. BOGERT, & G.T. BOGERT, TRUSTS AND TRUSTEES §228.

f. **Issues In Divorce Context With Spendthrift Trusts**. Issues that may arise include:

whether former spouses or children who have a support judgment are exception creditors;

whether exception creditors can reach spendthrift trust assets;

whether exception creditors can mandate a distribution from a discretionary trust;

whether exception creditors can reach or attach distributions after they are made from a discretionary trust or garnish them;

whether a trustee of a discretionary trust, knowing there is a judgment outstanding against the beneficiary for alimony or child support, can make a distribution to the beneficiary without first getting court approval; and

whether a trustee of a discretionary trust, where the beneficiary has a judgment outstanding for alimony or child support, may make a distribution *for the benefit of* the beneficiary and thereby avoid potential attachment that might apply if assets are distributed *to* the beneficiary.

g. **Control as a Factor**. Beneficiaries with substantial control over the trust who do not respect the trust formalities may subject the trust assets to potential creditor claims. *But see* UNIF. TRUST CODE §504(e) (creditors of beneficiary-trustee subject to ascertainable standard cannot reach trust assets). For example, assume that a beneficiary who is the trustee of a trust has an auto accident causing monumental damages and loses the tort trial resulting in a large judgment against him. The individual will likely be back in front of the same judge that tried the underlying tort case as the plaintiff tries to collect the judgment. The lawyer will ask if the individual was the sole trustee of the trust. Were proper trust procedures followed in administering the trust? Were trust accountings prepared? Were tax returns filed timely and correctly? Did the individual treat the trust as his personal checkbook? If the beneficiary/trustee has been sloppy in administering the trust, the trust may be penetrated. The trust does not provide absolute protection against creditors of the beneficiary. The fewer strings and less control that the beneficiary has over the trust, the more likely that the trust will stand up against creditor attacks on the trust.

Assets that would seem to be protected from beneficiaries' creditors under general spendthrift principles, however, may be more subject to claims in a divorce context.

46. Increasing Attacks in Divorce Proceedings

a. **Increasing Attacks; "A Different World."** The scenario described above with a trust beneficiary who has substantial control over the trust and who does not respect the trust also applies in the divorce context. The divorce judge in a court of equity is looking for equity and fairness and may be even more inclined than a judge in the traditional tort context to reach (or at least consider) the trust assets that are available to one of the spouses. Family lawyers are taking CLE courses about how to find assets in trusts and how to attack trusts. A case in Hong Kong awarded $1 billion of assets from a trust in a divorce matter.

b. **Third-Party Trusts or Trusts Created by a Divorcing Spouse.** The issue can arise either in situations in which one of the spouses was the settlor of a trust or was the beneficiary of a trust established by a third party. In the settlor context, if one spouse creates a trust naming that spouse as a discretionary beneficiary in a DAPT state, will the trust assets be considered as marital assets? Or if one spouse makes a transfer to an inter vivos QTIP trust or to a SLAT for the benefit of the other spouse, will those assets be treated as a gift to the other spouse, or will they be treated as marital assets?

c. **Example of Attacks on Third-Party Trusts - *Pfannenstiehl***. The *Pfannenstiehl* divorce litigation in Massachusetts is illustrative of the issues that can arise regarding trust interests in the third-party context. The trial court considered the husband's interest in a discretionary spendthrift trust created by his father as a marital asset, and ordered the husband to pay about $1.4 million from the trust to his wife. The trust provided for distributions to husband and the father's other descendants for their "comfortable support, health, maintenance, welfare and education" in the trustee's "sole discretion" as they "may deem advisable from time to time." The Massachusetts Supreme Judicial Court reversed the trial court's prior finding that the trust interest was part of the marital estate. The court did leave open two important issues for the trial court's consideration on remand: (i) the trust could be considered as an expectancy in determining how to divide the assets that are subject to division, and (ii) the court could revisit whether alimony is now appropriate in light of "any future stream of [trust] income from distributions." *Pfannenstiehl v. Pfannenstiehl,* SJC-12031, (Mass. Sup. Jud. Ct. Aug. 4, 2016). For a more detailed summary of *Pfannenstiehl*, see Item 7.i of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

47. Fundamental Issues Regarding Property Division in Divorce.

Divorce basics are that (i) marital property (or community property) is identified and divided equitably, and (ii) support and alimony are determined separately based on various factors. Whether trust assets can be reached in a divorce context arises with respect to these two separate issues: (i) equitable distribution of the marital assets (and whether some or all of the trust assets are treated as marital assets that can either be taken out of the trust and awarded to the other spouse or can be taken into account in dividing all of the marital assets), and (ii) whether the trust assets can be considered in setting maintenance or alimony (and secondarily if the trust assets can be reached if such payments are not made). Under the laws of many states, all income of a spouse, whether treated as a marital asset or not, is included in determining the ability to pay alimony.

Assets acquired during the marriage are typically treated as marital property subject to division, but gifts and inheritances are typically not treated as marital assets (or are allocated to the spouse who received the gift/inheritance). Major factors influencing whether trust assets are marital property are the use of the trust property during the marriage and restrictions (or lack of restrictions) in the trust agreement on the beneficiary's access to the trust assets.

48. Impact of Trust Choice of Law Provision and Trust Situs

a. **Particularly Favorable Jurisdictions**. Where the trust was settled, the choice of law provision, the trust situs, and the place of the divorce may all have an impact on the ability to reach trust assets in the divorce proceeding. For example, some states (such as Nevada, Alaska, and South Dakota) do not provide for exception creditors to a spendthrift trust. Some planners believe that trusts created under the law of these states provide the greatest possible protection against a potential claim by the divorcing spouse of a trust beneficiary.

   South Dakota Codified Laws §55-1-35 states: "Regardless of whether a beneficiary has any outstanding creditor, a trustee of a spendthrift trust may directly pay any expense on behalf of such beneficiary and may exhaust the income and principal of the trust for the benefit of such beneficiary. No trustee is liable to any creditor for paying the expenses of the beneficiary of a spendthrift trust." In providing that a creditor cannot reach assets in a discretionary trust, the term "reach" is defined as including by garnishment or attachment. § 55-1-24(6). A beneficiary's support interest does not rise to the level of a property interest. §55-1-42. "If the trust contains a spendthrift provision, notwithstanding the beneficiary's right to force a distribution with regard to a mandatory or support interest, no creditor may force a distribution [nor reach a present or future support distribution] with respect to a mandatory or support interest." *Id.* Further, a discretionary interest is explicitly defined as a "mere expectancy," and "[n]o creditor may force a distribution with regard to a discretionary interest. No creditor may require the trustee to exercise the trustee's discretion to make a distribution with regard to a discretionary interest." § 55-1-43(1)-(2).

   Nevada has no statutory allowance for exception creditors, and Nevada specifically disallows claims of spouses, former spouses, children, or dependents. Nevada Revised Statutes §166.090 provides that a "[p]rovision for the beneficiary will be for the support, education, maintenance and benefit of the beneficiary alone, and without reference to or limitation by the beneficiary's needs, station in life, or mode of life, or the needs of any other person, whether dependent upon the beneficiary or not." Section 166.080 adds that "[t]he beneficiary or beneficiaries of such trust shall be named or clearly referred to in the writing. No spouse, former spouse, child or dependent shall be a beneficiary unless named or clearly referred to as a beneficiary in the writing." The trustee's exercise of discretion in a Nevada discretionary trust can only be reviewed if the trustee acts "dishonestly, with improper motive or fails to act." §163.419(1). "Regardless of whether a beneficiary has an outstanding creditor, a trustee of a discretionary interest may directly pay any expense on the beneficiary's behalf and may exhaust the income and principal of the trust for the benefit of such beneficiary. §163.419(4). Section 163.417 provides that a creditor may not exercise and a court may not order the exercise of a power of appointment, any power held by a trust protector, or a trustee's discretion to make distributions or take any other authorized action in a specific way.

b. **Impact of Choice of Law Provision**. The choice of law provision in the trust agreement will not automatically control, however. The governing law provision in the trust instrument generally controls "unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue." UNIF. TRUST CODE §107(1); RESTATEMENT (SECOND) OF CONFLICT OF LAWS §270. Issues arising in the marital and family context are often considered as raising uniquely powerful public policy issues.

The public policy issues tend to be much stronger in divorce cases than in traditional creditor cases, and in many situations, the law of the place of the divorce will control. For example, in *Dahl v. Dahl*, 345 P.3d 566 (Utah 2015), spouses were divorced in Utah, and before the divorce, the husband had created a self-settled trust under Nevada law (which provided creditor protection to the settlor-beneficiary). The court did not consider whether the trust assets were part of the marital estate because the wife's attempt to join the trust as a party shortly before the trial was rejected as being untimely. The wife brought a separate action, also in Utah, seeking a declaration of her rights in the trust assets and requesting an accounting. The Utah Supreme Court considered both the divorce and declaratory judgment actions in a consolidated case. It reasoned that Utah's choice of law rules would enforce a choice of law provision in a trust unless it would "undermine a strong public policy" of the state. The court concluded that it could not apply Nevada law without violating Utah public policy. *Id.* at 579.

49. Drafting Considerations for Third-Party Trusts

a. **Use Multi-Generational Discretionary Pot Trust for Beneficial Interests of Children and Further Descendants**. A trust with a third-party trustee and multiple beneficiaries that does not have standards that the trustee must take into consideration in making discretionary distributions offers significant protection against claims by a divorcing spouse of a discretionary beneficiary of the trust. For example, in *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991), the trustee had complete discretion to distribute income and principal to any of the wife in the divorce action, her father, and her descendants. The trust continued until the last to die of the wife and her father, at which time the assets would pass outright to the wife's descendants. The court concluded that the wife's interest was a "mere expectancy" and the appreciation in value during the marriage could not be considered as part of a marital property division as would otherwise be the case under Colorado law for the appreciation in value of separate property. The wife had no "vested 'property' right to receive payment from the trust."

b. **Significance of Ascertainable Standards.** A beneficiary can argue lack of any control over the trust and distributions if distributions may only be made in the full and absolute discretion of a third-party trustee. As discussed in Item 45.c-d above, under the Uniform Trust Code, if the trust has ascertainable standards, whether or not subject to the trustee's discretion, the trustee can be compelled to make distributions to satisfy a judgment for support of the beneficiary's spouse or former spouse. UNIF. TRUST CODE §504(c). The presence of an ascertainable standard may even cause the trust to be treated as marital property in some states. *E.g., Comins v. Comins*, 33 Mass. App. Ct. 28, 30-31 (1992), *distinguished in Pfannenstiehl v. Pfannenstiehl*, 55 N.E.3d 933 (Mass. 2016).

c. **Independent Trustee.** Divorce courts may give more deference to discretionary distribution decisions made by a disinterested, independent trustee. Any third-party trustee would be safer than the beneficiary as trustee. Indeed, if a beneficiary-trustee resigns as trustee during the divorce proceedings, the beneficiary could potentially be held in contempt. *See In re Kloiber*, 98 A.3d 924 (Del. Ch. 2014).

d. **Expand Spendthrift Provisions**. Consider drafting the spendthrift clause to refer specifically to a spouse and former spouse.

e. **Powers of Appointment**. Powers of appointment add significant flexibility, such as the ability to appoint the assets to someone other than the beneficiary going through a divorce or to remove the beneficiary's interest in the trust.

f. **Liberal Decanting Clauses.** Include a provision giving the trustee broad decanting authority that would allow changing beneficial interests in the event of a problem situation in order to best carry out the settlor's intent.

g. **Separate Letter of Wishes**. Instead of setting forth in the trust instrument the settlor's non-binding wishes as to distributions over time, consider using a separate letter of wishes. Examples of clauses that such a letter might include are the following:

> It is our express intention that these trusts preserve wealth indefinitely for the benefit of our descendants and provide the maximum legal protection of the assets held in trust against the claims of any person whomsoever.
>
> …
>
> The letter is to express our wishes to you when exercising discretion as to making or not making distributions to beneficiaries. We appreciate that our wishes do not bind you in any way and that you remain free to make distributions as you see fit in the exercise of your unfettered discretion. We have no understanding or agreement with any of you as to distributions, and this letter is not meant to establish any such understanding or agreement. The contents of this letter are not intended to constitute terms of any trust and are not intended to establish or imply any standard to guide any fiduciary in exercising discretion. These wishes are merely for your consideration to the extent that you deem advisable under the circumstances.
>
> …
>
> In general, it is our wish that our assets remain protected over time from the reach of any creditor or potential creditor of any descendant or ours, including, but not limited to, a spouse, or former spouse. Please consider preconditioning any distribution on the beneficiary's undertaking to enter into a valid marital property agreement or valid choice of governing marital property law that, in your judgment, would serve to protect the distribution from the claims of a spouse or former spouse.

50. Trust Administration Considerations

The following trust administration considerations, suggested in Jocelyn Borowsky & Rebecca Wallenfelsz, *Third Party Spendthrift Trusts in the Context of Divorce*, 42ND ANN. NOTRE DAME TAX & EST. PL. INST. (Oct. 28, 2016),may also assist in insulating trust assets in a divorce proceedings:

- No patterns of distribution;
- Formalize the discretionary decision-making process regarding distribution decisions;

- Modifying problematic aspects of the trust agreement prior to the divorce (preferably well prior to the divorce);
- Delay distributions if a beneficiary's divorce is anticipated or following entry of a judgment in a divorce proceeding;
- Seek court intervention by the trustee to protect the trust (for example, petitioning for instructions, a declaratory judgment, or a protective order);
- Avoid drastic changes in administration during divorce proceedings;
- Consider migrating the trust to a state with stronger creditor protection; and
- When a beneficiary is involved in a contested divorce proceeding, engage counsel and consider what the trust can reasonably do to protect itself and to consider the extent to which the trust could or should participate in the settlement discussions to minimize dissipation of the trust.

51. Modifications to Prior Trusts by Divorcing Spouses

Spouses who are divorcing may want to make adjustments to trusts that one or both of them have created. Potential issues may include the following:

- Changing a trust so that it is no longer a grantor trust by changing trustees (if that impacts the grantor trust status), which may involve trustee resignations and revisions to the designation of successor trustees by a trust modification or decanting transaction;
- Changing the grantor trust status, depending on what other provisions cause the trust to be a grantor trust (which may be accomplished by the exercise of inter vivos powers of appointment, non-judicial modification, judicial modification, or decanting);
- Income from a trust that is a grantor trust as to a donor-spouse may nevertheless be taxed to other spouse under §682 to that extent that income distributions are made to the beneficiary-spouse who is entitled to receive income distributions from the trust, but this does not impact taxable income arising from trust corpus, see Item 17.n of the 2016 Heckerling Musings found **here** and available at **www.Bessemer.com/Advisor**;
- Modifications may involve income tax issues (under the *Cottage Savings* case), but the trend of PLRs is to find that a modification is not an income realization event under *Cottage Savings* if the action is authorized under the terms of the trust instrument or state statute or court approved settlement of a bona fide dispute;
- Modifications may also impact the inclusion ratio for GST purposes, but by analogy to the provisions in the regulations regarding the modification of "grandfathered" trusts, modifications that do not require court approval will not impact the inclusion ratio as long as the modification does not extend the vesting of interests beyond the rule against perpetuities period applicable to the trust; modifications requiring court must also avoid shifting any beneficial interest to lower generation beneficiaries, Treas. Reg. §26.2601-1(b)(4); and

- Transfers between spouses that are pursuant to property settlement agreements, if the divorce occurs within a 3-year period beginning one year before the agreement is entered, will avoid being taxable gifts under §2516.

Items 52-53 are observations from a seminar by Robert Borteck, Frayda Bruton, Gary Ruttenberg, and Glen Yale, Settlement Agreement: Considerations When Negotiating, Drafting and Enforcing Settlement Agreements Involving Probate, Trust and Guardianship Disputes.

52. General Contractual Issues

A settlement agreement is governed by contract law. General terms and provisions that may be addressed in settlement agreements include the following:

- The settlement agreement should comply with requirements in the state rules of civil procedure;
- Clearly identify parties to the agreement who are releasing claims or who are being released and the capacity in which they are signing (including all necessary parties);
- The agreement should make clear that a real justiciable controversy exists;
- Clearly define all known claims and transactions being released and whether any related unknown claims are also being released; the scope of a release is determined by the intention of the parties as expressed in the agreement, but most courts construe releases narrowly to avoid injustice and forfeiture of claims;
- Consideration should be described (a mutual agreement of compromise or avoiding a contest is itself valuable consideration);
- The parties may contractually agree to a choice of law and/or forum (which must have some relationship to the parties and the agreement);
- Releases are obviously very important aspects of settlement agreement; releases should be carefully drafted so they are neither too broad nor too narrow;
- Indemnities may be included in the agreement to protect against potential claims by third parties;
- Consider including a mechanism to resolve future disputes relating to the settlement agreement (such as mediation or arbitration);
- The agreement should negate any reliance on statement made by any of the attorneys;
- In many situations, the parties will want to provide that the agreement is confidential;
- The agreement is not interpreted unfavorably against a party who drafted the agreement;
- Recitals that each party has the legal capacity to sign the agreement and has full knowledge of the circumstances surrounding the agreement;

- Payment of attorneys’ fees and expenses is often a material term;
- The enforceability of the agreement can be conditioned on certain events or actions, or the agreement may contemplate the parties taking certain actions;
- Standard boilerplate provisions include provisions such as, severability of provisions, modification or amendment, interpretation, effect of waiver of requiring performance of any particular term of the agreement, execute further instruments necessary to implement the agreement, effect of agreement, captions, entire agreement, counterparts, no express or implied lien, disclaimer of fiduciary relationship, confidentiality, declarations that each party has read and understands the agreement and understands that the party is permanently surrendering claims; and
- The general practice in some states is to have the parties appear in open court and state on the record that they agree to the terms of the settlement.

The materials include various settlement agreements example forms.

53. Tax Effects

The general tax effects of settlement agreements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings found **here** and available at **www.Bessemer.com/Advisor**;