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ACTEC 2020 Annual Meeting Musings

March 2020

The American College of Trust and Estate Counsel is a national organization of approximately 2,500 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 the seminars at the 2020 Annual Meeting and does not purport to represent the views of ACTEC as to any particular issues.

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Introduction

Some of my brief observations from the 2020 ACTEC Annual Meeting Seminars in Boca Raton, Florida on March 6-8, 2020, are summarized below. (At the request of ACTEC, the summary does not include any discussions from Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely selected issues from the seminars. The summary is based on the presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-13 are observations from a seminar by Cynda Ottaway, Todd Angkatavanich, and Keri D. Brown, Hot Topics

1. Legislative Proposals

Prominent Democrats, including some who were previously Democratic Presidential candidates, have proposed various legislative tax changes, some of which, if enacted, would have significant estate planning implications. Former Vice President Joe Biden proposes ending the step-up in basis at death on capital gains exceeding $100,000. Senator Bernie Sanders would go further and accelerate gain recognition at death and upon making gifts (with a lifetime exclusion of $250,000 of gains). Senators Warren and Sanders both proposed an annual wealth tax. Michael Bloomberg also proposed eliminating basis step-up at death.

Senator Sanders on January 31, 2019, introduced S. 309 titled "For the 99.8 Percent Act," which would reduce the basic exclusion amount to $3.5 million (not indexed) for estate tax purposes and to $1.0 million (not indexed) for gift tax purposes and increase the rates: 45% on estates between $3.5 and $10 million, 50% on $10 million - $50 million, 55% on $50 million - $1 billion, and 77% over $1 billion. (The GST rate is not specifically addressed, so presumably it would be the highest marginal estate tax rate of 77% under §2641(a)(1), with a $3.5 million GST exemption.) The bill would make major changes to the transfer tax system including substantially limiting valuation discounts, imposing additional restrictions on GRATs, causing grantor trust assets to be included in the deemed owner's gross estate, and providing that trusts would be GST exempt only if they could not last longer than 50 years. This bill is significant, even though Senator Sanders can no longer be the Democratic Presidential nominee; these are proposals that have been suggested by others from time to time, but have not been reduced to statutory text that can be pulled off the "shelf" to incorporate into whatever other legislation happens to be popular at the time. For a more detailed discussion of the "For the 99.8 Percent Act," see Item 2.e of Heckerling Musings 2020 and Estate Planning Current Developments (March 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

Various other Democrats have proposed accelerating the sunset of the doubling of the $5 million (indexed) gift, estate and GST exemption amounts sooner than 2026.

All of these developments suggest that if the Democrats win the Presidency or Senate in the 2020 elections, some clients may want to make transfers in late 2020 for fear that legislation in 2021 rolling back transfer tax exclusions or enacting other transfer tax reforms might be made retroactive to sometime in early 2021.

2. Section 2703 "Device" Test Does Not Apply for Gift Tax Purposes, Tax-Affecting, *Kress v. U.S.*

Kress v. U.S., 372 F. Supp.3d 731 (E.D. Wisconsin 2019), is a very interesting case with respect to various valuation issues. It is a gift tax refund case, with the sole issue being the value of minority interests in S corporation stock.

The court reasoned that the "not a device" test in §2703(b)(2) was not applicable to the gift tax case because it applied only to transfers from decedents. The court, however, held that the taxpayers did not meet the comparability test of §2703(b)(3) because "they have not produced any evidence that unrelated parties at arms' length would agree to such an arrangement," but the lack of marketability discount was reduced by only 3% as a result of a "Family Transfer Restriction."

Both the taxpayer and government experts tax-affected the earnings of the S corporation to apply a C corporation level tax in order to compare the S corporation being valued to other C corporations that were used as comparables. The case had little discussion about the tax-affecting issue, but the court generally adopted the approach of the taxpayer's report, which included tax-affecting in its income approach analysis.

For a more detailed discussion of *Kress*, see Item 33 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

3. Valuation of Timber Using Income Approach, Tax-Affecting, *Estate of Jones*

Estate of Jones v. Commissioner, T.C. Memo. 2019-101 (August 19, 2019, Judge Pugh) determined the gift tax value of gifts of interests in an S corporation and limited partnership that owned, among other things, a very large tract of timberland. The taxpayer reported a gift value of about $21 million, and the IRS asserted a gift value of about $120 million.

a. **Income Approach.** The most significant issue from a monetary standpoint is that the timber is valued under the income method rather than the net asset value method. The asset-approach value was about four times larger than the income-approach value. In this situation where there is an ongoing business operation and the facts are clear that the timber will not be liquidated and the transferee would have no ability to force the liquidation, the income-approach was appropriate. (This case would have been appealable to the Ninth Circuit Court of Appeals, and *Estate of Giustina v. Commissioner*, 586 F. App'x 417, 418 (9th Cir. 2014) had similarly held that no weight should be given to an asset-based valuation in valuing timberland in that case because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record.)

b. **Tax Affecting.** Another interesting issue is that the Tax Court concluded that "tax-affecting" the earnings of the S corporation and limited partnership was appropriate in determining the valuations of the entities under the income method. The Tax Court has been reluctant to accept tax-affecting following its decision twenty years ago in *Gross v. Commissioner*. That may be changing.

Judge Pugh reasoned that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax-affecting the earnings of a flowthrough entity per se. Instead, Judge Pugh viewed the issue as fact-based, and noted that the court in those cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases, including that the taxpayer's appraiser had considered the disadvantages of S corporations (and therefore made an adjustment by tax-affecting the earnings), but did not consider the advantages of S corporations. Judge Pugh concluded that the taxpayer's appraiser did consider the advantages as well as disadvantages of flowthrough treatment and that the detailed tax-affecting analysis was appropriate:

> We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flowthrough status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy. … Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

For a more detailed discussion of *Jones*, see Item 34 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

4. Improper to Value LLC Units Under Assumed Subsequent Events That Are Not Reasonably Probable, *Grieve*

a. **Synopsis.** In *Grieve v. Commissioner*, T.C. Memo. 2020-28 (March 2, 2020), Judge Kerrigan upheld a donor's gift tax valuation of 99.8% nonvoting interests in two limited liability companies that he had given in 2013 to a GRAT and to another irrevocable trust. The assets held by the LLCs were largely cash, cash equivalents, and marketable securities. The donor's gift tax return applied entity-level discounts for lack of control and marketability totaling about 35%.

The Tax Court did not use an alternative approach the donor offered at trial that included "multiple-tiered discounts," reasoning that taxpayer had admitted to a higher value on the appraisal attached to the gift tax return (without any specific criticism of the multiple-tiered discounting approach).

The court firmly rejected a valuation offered by the IRS that assumed that a buyer of the 99.8% class B nonvoting interest would start by seeking to buy the 0.2% class A controlling interest, which the appraiser assumed (without empirical data) could be purchased for a 5% premium. The IRS appraiser's approach would have almost eliminated any entity-level discounts (leaving a discount of just over 1.4%).

b. **Rejection of IRS's "Game-Theory" Approach.** The court rejected the IRS's approach of valuing the donor's non-controlling class B units assuming that the hypothetical buyer would first buy the 0.2% class A controlling units, which would in turn impact the value of the non-controlling units. The 0.2% controlling interest was owned by the donor's daughter, who testified that she had no intention of selling the units, that if she sold the units she would demand a much higher premium, and that if the units were ever sold outside the family, she would require that she be paid a management fee.

The court reasoned—

> We are looking at the value of the class B units on the date of the gifts and not the value of the class B units on the basis of subsequent events that, while within the realm of possibilities, are not reasonably probable, nor the value of the class A units.

c. **Concurrent Testimony of Experts.** A footnote observed that "[w]ith agreement of the parties we directed the expert witnesses to testify concurrently. The procedure was implemented in substantially the same way as in Rovakat, LLC v. Commissioner, T.C. Memo. 2011-225 [affirmed, 529 Fed. Appx. 124 (3d Cir. 2013)]."

The engagement of expert witnesses around a table like this has been referred to colloquially as "hot tubbing," and in *Rovaka*t Judge Laro actually cited an article titled "Experts in the Tub" (21 Antitrust 95, 97 (2007)).

d. **Multi-Level Tiered Discounts.** *Grieve* rejected on procedural grounds the approach offered by an expert at trial for the taxpayer applying tiered discounts (because that approach resulted in a value considerably lower than the value reported on the appraisal attached to the gift tax return), but without any specific criticism of the multiple-tiered discounting approach.

Discounts at multiple levels of interests owned by partnerships were allowed in *Astleford v. Commissioner*, T.C. Memo. 2008-128. The court in *Astleford* allowed full lack of control and marketability discounts at both the subsidiary level and the parent level. The cases cited by the court suggest that this is appropriate when there are minority interests being valued at both levels. Footnote 5 of the *Astleford* opinion cites four Tax Court and Tax Court memorandum cases that have allowed multi-level discounts where there were minority interests in both levels. (*Estate of Piper, Janda, Gow,* and *Gallun*.) However, cases have refused to apply multi-level discounts where minority interests in subsidiaries were a significant portion of the parent entity's assets (*Martin*) or for a subsidiary that was the parent's "principal operating subsidiary" (*Estate of O'Connell*).

e. **More Detailed Summary.** For a more detailed summary of *Grieve,* see Item 40 of Heckerling Musings 2020 and Estate Planning Current Developments (March 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

5. FLP Assets Included in Estate Under Section 2036(a)(1); Application of Section 2043 Consideration Offset Regarding Section 2036 Transfer; Formula Transfer to Charitable Lead Trust Not Respected, *Estate of Moore*

Estate of Moore v. Commissioner, T.C. Memo. 2020-40 (April 7, 2020), was decided after the 2020 ACTEC Annual Meeting. The following are some important recurring issues that the court addresses.

- Land contributed to an FLP is included in the estate under § 2036(a)(1), with a lengthy discussion of the § 2043 "consideration offset" adjustment.

- A formula transfer to charity in light of the inclusion of additional assets in the gross estate following an estate tax audit is not given effect.
- Loan proceeds are gifts because notes documenting the loans are not treated as bona fide debt.

For a detailed summary of the case and a discussion of planning observations, see Estate of Howard V. Moore v. Commissioner Summary available **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

6. Transfer Planning With Qualified Opportunity Funds

a. **General Tax Advantages.** The three big tax advantages for investments in qualified opportunity funds (QOFs) under §1400 Z-1 and §1400 Z-2 are: (i) Deferral of existing gain until December 31, 2026; (ii) Exclusion of a portion of the existing deferred gain (10% or 15%, depending on how long the fund investment is held—to get the full 15%, the investment had to be made before December 31, 2019, so a big rush to purchase funds occurred in December); and (iii) Nonrecognition of gain in the QOF investment itself if the interest in the fund is held at least 10 years.

b. **Third Advantage Particularly Advantageous for Transfer Planning.** Transfers of interests in qualified opportunity funds offer the opportunity of removing future growth from the transferor's estate and allow the recipient to avoid paying income tax on the future growth (as long as an inclusion event does not occur, discussed immediately below).

c. **Inclusion Events.** Regulations refer to certain transfers of qualified opportunity fund interests as "inclusion events" that result in loss of the tax advantages, including the third advantage of nonrecognition of gain in the QOF if the interest is held at least 10 years. Gifts are generally treated as inclusion events, unless the gift is to a grantor trust. Final regulations confirm that nonrecognition transactions between the "deemed owner" and the grantor trust are not inclusion events. This seems to include things such as –

- sales of QOF interests to a grantor trust,
- in-kind note payments from a grantor trust to the grantor,
- the grantor's exercise of a substitution power, and
- distributions of QOF interests to satisfy GRAT annuity payments.

Death is not an inclusion event, including transfers by reason of the owner's death.

d. **Basis Step-Up at Death.** The final regulations state that there is no basis step-up at death in the QOF investment to the extent that the value at death exceeds the deferred gain. (ACTEC Comments had recommended that approach.)

7. Other Transfer Planning Issues

a. **IRS Challenges Regarding Sales to Grantor Trust Transactions.** The IRS is raising some challenges in audits regarding sales to grantor trusts, including the fair market value of the asset sold to the trust and the value of the consideration (the note from the grantor trust). Appraisers are sometimes used to value such notes. A consideration is the ability of the trust to pay the note. The IRS also on occasion has made arguments that assets sold to a grantor trust should be included in the seller's gross estate under §2036 and §2038 (this argument was made in the *Estate of Beyer v. Commissioner* case, which was settled).

b. **Formula Clauses.** Tax litigators continue to see IRS challenges to defined value formula transfer clauses. The IRS is continuing to look for the next *Wandry* case, appealable to the "right" circuit court of appeals. Cases involving formula clauses are often settled, with the taxpayer giving up on the formula clause issue, but the valuation clause is a "bargaining chip" in the negotiations.

c. **Lifetime Gifts of Low Basis Assets; "Appreciation Hurdle."** The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property. Be wary of making gift of low-basis assets, particular if the donor is in old age or near death. For a discussion

of David Handler's "appreciation hurdle" chart, see Item 10.k. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

d. **Follow Formalities and Document Transfers.** In the course of structuring sophisticated transfer planning strategies, be sure to take the "simple" steps of following formalities (obtain necessary consents of co-owners, etc.) and document the transfer appropriately.

In *Knop v. Knop*, 830 S.E.2d 723 (Va. 2019), the court ultimately agreed with a donor who asserted that gifts of closely-held stock were invalid because of the failure to deliver the stock certificates, even though the change of ownership had been reflected on the Schedule K-1s issued each year. The IRS could use that same concept to argue that gift assets were still owned by the purported donors.

Items 8-11 are observations from a symposium by Kathleen Nalty (a Diversity and Inclusion Consultant in Denver, Colorado) and Stephanie Perry, What You Don't Know Can Hurt You: The Impact of Unconscious Bias on the Practice of Law

8. Overview and Significance of Unconscious Bias

Researchers believe that as much as 80% or more of our thought processes are at the unconscious implicit level, controlled by the automatic intuitive part of our brain. Conscious thinking takes an immense amount of energy--30% or more of the energy we use each day. To save energy, most of our routine thinking is in the unconscious mind.

Our unconscious minds are influenced by many things from the time that we were young children. The biggest of these is cultural influences. For example, Kathleen told the story of putting up a Christmas tree. Her husband was extremely frustrated that the string of lights would not work. Eventually, Kathleen could not take the complaining any further and she grabbed the strand from her husband to see if she could fix it. Her three-year old son stood in front of her with his hands on his hips and proclaimed: "Mom, you're just being a female." Kathleen was aghast, wondering how her three-year old son could come up with such a comment. Sometime later, she noticed him watching a Snow White video, which he loved and watched over and over. At one point on the video, Grumpy said "She's a female. And all females is poison. They're full of wicked wiles." Even at three-years old, cultural influences were creating biases.

"None of you were born biased. You learned it."

Our conscious minds generally cannot control our unconscious minds. Conscious thinking has difficulty accessing what our unconscious minds are up to. (That would be like asking what your pancreas is up to right now.) There are no filters as to what might be embedded in the backs of our minds. Certain techniques, however, can help us become aware of what we keep in unconscious biases. To some extent, we are able to re-script what might be in the backs of our minds.

"We are all two persons at the same time. If you're human, you have bias."

Unconscious biases are not inherently bad; indeed, we could not function without them. But they may encompass attitudes and stereotypes that we may not be endorse as appropriate if we become aware of them.

9. Types of Unconscious Biases That Interfere With Good Decision Making

a. **Illusion of Objectivity.** The illusion of objectivity bias keeps us from fully acknowledging that we have biases. In fact, studies show that assuming we are not biased makes us even more biased. Despite our best efforts, at the unconscious level we cannot be gender blind, colorblind, etc.

As an example, recruiters believe they do not have racial biases. Over 10 years ago, researchers sent 5,000 identical resumes in response to actual employment ads. The only differences were that half the ads had a name signaling the person was African-American, and the others had a name signaling a white individual. The white person received 50% more callbacks. Another test in 2012 tested gender bias among research scientists–who generally think they are not gender biased. Identical

resumes were sent to 127 research scientists in university labs responding to employment ads for a lab manager position, except that on one-half of the resumes the applicant's name was Jennifer and the other one-half the applicant's name was John. Jennifer was viewed as less competent and her starting offering salary would have been significantly less than John. Most interestingly, there was no significant statistical difference between the male and female reviewers; the female reviewers demonstrated just as much implicit bias against the female applicant.

b. **Attribution Bias.** Attribution bias attributes characteristics based upon a person's group, with group stereotypes. People in the "out-group" are judged negatively by group stereotypes and are not given the benefit of doubt.

c. **Availability Bias.** An example of availability bias is that people frequently fill in the blanks in a situation with what is more available to them (e.g., their in-group).

d. **Anchoring Bias.** The anchoring bias concept is that the unconscious mind gets anchored to something it is exposed to, which then influences a later decision. For example, in a research study involving 167 U.S. Magistrate judges, the judges were given a fictitious case study and were asked to decide for the plaintiff or defense and award damages as appropriate. Half of the judges had no anchor. The other half saw the same case study but also saw a jurisdictional motion involving a $75,000 limit. The judges who saw the jurisdictional motion awarded 50% less in damages than the group of judges who never saw the motion.

e. **Confirmation Bias.** Confirmation bias causes people to pay more attention to information that confirms their belief system and pay little attention to information that contradicts their beliefs. In a "Writing Analysis" study, a legal research memo that had 23 mistakes were sent to partners in law firms for them to give feedback to assist the writer with writing skills. Half were told that the writer was white and half were told the writer was African-American. The overall average ratings were significantly lower for the African-American group. Shockingly, there was no appreciable difference between the white partners and racially/ethnically diverse partners who participated in the study.

f. **Affinity Bias.** Affinity bias causes us to gravitate toward people who are like us and share similar interests and backgrounds. This type of bias is particularly pervasive.

10. Diversity and Inclusion in Legal Practice and How Bias Interferes

a. **Diversity vs. Inclusiveness.** *Diversity* focuses on recruiting; it is about diversity in the workplace. *Inclusiveness* focuses on retention and advancement within the firm. Inclusiveness involves everyone in the firm, not just the recruiters. Inclusiveness is all about creating an environment in which everyone has what they need to do their best work for the organization.

b. **Ten Hidden Barriers.** The legal profession is near the bottom of all professions regarding inclusiveness, leading to a revolving door with high attrition rates. A prime reason is the limited access to intangibles that are critical to career success. Ten hidden barriers are: (1) networking opportunities; (2) information from internal networks (insider information), (3) work assignments (amount, type, and profile), (4) mentoring (which helps "skill up")) and sponsors (which help "move up"), (5) training development, (6) client contact, (7) access to decision makers, (8) social isolation, (9) receiving inadequate feedback and soft evaluations, and (10) being denied promotions.

The MeToo and Time's Up movements have created even more barriers. Sixty percent of male managers distance themselves from female employees, resulting in even more discrimination against women.

c. **Unconscious Bias and Affinity Bias.** Unconscious biases, and in particular affinity bias (which is a bias in favor of others who are more like you) are primarily responsible for these disparate opportunities. When senior attorneys (the vast majority of whom are white and male) gravitate toward and share opportunities with others who are like themselves, they unintentionally but disproportionately leave out female, LGBTQ, disabled, and racially/ethnically diverse attorneys. If you are not intentionally including everyone, you are unintentionally excluding some.

11. Strategies For Interrupting Implicit Bias

a. **Awareness.** Good intentions are not enough to solve the problem.

Be Aware of Implicit Bias. The starting point of interrupting implicit bias is to recognize that it exists. The Implicit Association Test (available at **www.ProjectImplicit.org**) takes about 5-10 minutes to complete. It is based on how fast or slow (measured in milliseconds) a person is in reacting to association questions – the unconscious results come more quickly but concepts in the conscious mind are slower. It gives an indication of one's implicit biases with respect to various categories.

Pay Attention to Surprises. Pay attention to situations in which assumptions or expectations about a person or group turn out to be wrong. The gap between expectation (stereotype) and reality is where implicit bias lies. Even consider keeping a "Surprise Journal."

b. **Behavior Change.** Various bias-breaking activities will help keep biases from translating into behaviors.

- Actively doubt your objectivity. When you notice yourself making a judgment about someone, challenge it.
- Increase your motivation to be objective and fair.
- Expose yourself to counter-stereotypic examples.
- Shift perspectives (put yourself in someone else's shoes).
- Find commonalities with others.
- Find one trait you admire in each colleague.
- Decrease exposure to stereotype-inducing stimuli.
- Audit decision-making for affinity bias (who are your sponsoring? spending time with? bonding with? giving second chances to?).

c. **Structural Change.** Individual behavior changes often have to be supported and encouraged by structural changes in an organization in order to have the greatest impact on interrupting implicit biases.

- Mansfield Rule (like the Rooney Rule in the NFL). Various large law firms have committed to require at least 30% of its leadership candidates be minorities, women, and LGBT candidates.
- Blind resumes (at least in the initial round of review).
- Structured interviews.
- Anonymous work assignment systems.
- Increase accountability.
- Make decisions collectively in diversified decision-making groups.
- Build support systems.
- Institute continuous education opportunities.
- Develop clear guidelines and criteria for evaluation and promotion decisions.
- Institutionalize programs that provide exposure to diverse exemplars.

Items 12-15 are observations from the Annual Joseph Trachtman Memorial Lecture by Duncan E. Osborne: Truth, Transparency and the Right of Privacy

12. Truth, Transparency, and Privacy

The fabrication of facts is reaching the highest levels, and not just by politicians. Individuals no longer trust institutions, which is a threat to democratic processes. How can we organize as a society and resolve differences if we cannot agree on simple reality? This trend is especially troubling for lawyers, because lawyers are the ultimate guardians of the truth.

Transparency is the handmaiden of truth, but transparency has its limits. The preservation of privacy is just as important as transparency.

Duncan's obsession with truth, transparency, and privacy began some years ago with his representation of ACTEC on the Financial Action Task Force (FATF).

13. Financial Action Task Force (FATF)

The Financial Action Task Force ("FATF") was first formed in 1989 during the G7 Summit in Paris, France. It is an intergovernmental group of 37 member jurisdictions, two regional organizations, and other associate members. Its purpose is to counter money laundering and terrorist financing. The member countries are expected to adopt the recommendations of the Task Force.

Within a year after FATF was created in 1989 it adopted 40 Recommendations for financial institutions to combat money laundering.

In 2001, the scope of FATF was extended to cover terrorist financing, and in October 2001 FATF issued *Eight Special Recommendations* dealing with terrorist financing.

In 1999, FATF sought to expand its rules beyond financial institutions to Designated Non-Financial Businesses and Professions (DNFBPs). These are persons deemed to be gatekeepers to domestic and international financial systems, and FATF believes they should comply with the 40 Recommendations. The DNFPB gatekeepers include lawyers, notaries, accountants, trust company service providers, real estate agents, casino operators, art dealers and dealers in precious metals and stones.

In 2003, FATF issued Recommendations for DNFBPs (including lawyers) that include procedures and requirements for customer due diligence, know your customer, maintaining customer due diligence records, monitoring customers and transactions on an ongoing basis, filing suspicious activity reports with no tipping off. The FATF Recommendations apply to legal professionals only when they undertake specified transaction activities (not including litigation) described in Recommendation 22. Those areas (in which FATF says the Customer Due Diligence, Suspicious Activity Reporting and No Tipping Off obligations would apply) include lawyers assisting in buying and selling real estate or business entities, organizing contributions for the creation, operation, or management of companies, or creating, operating, or managing legal persons or arrangements (which they mean to include trusts). The filing of suspicious activity reports on clients is antithetical to the attorney-client relationship as we know it, and the ABA expressed strong opposition that such requirements would be inconsistent with the attorney's duty of loyalty, duty of confidentiality, concepts of attorney-client privilege, the Sixth Amendment right to counsel, and the independence of the Bar.

Since 1776, the United States has been preoccupied with protection of the individual. The Bill of Rights is designed to protect the individual from the state. "That is why lawyers are so important in our legal system." In effect, FATF is asking attorneys to become agents of the state.

In 2008, FATF issued a risk-based guidance paper for lawyers, the RBA Guidance for Legal Professionals, which closely parallels the substance and format of FATF's guidance for the financial services sector.

The U.S. has resisted making lawyers gatekeepers to the financial system, and no federal or state law requires lawyers to assume the obligations that FATF recommends and that most European nations have embraced. The ABA and ACTEC have been able to convince U.S. lawmakers and the U.S. Treasury that self-regulation of lawyers and a concerted effort at education of lawyers about money laundering and terrorist financing issues are sufficient.

The ABA responded by adopting the ABA Voluntary Good Practices Guidance for lawyers. Among other things, it requires lawyers to assess risk as part of client due diligence. In 2014 the ABA in collaboration with the International Bar Association and the Council of Bars and Law Societies of Europe published "A Lawyer's Guide to Detecting and Preventing Money Laundering."

Formal Opinion 463 of the American Bar Association Standing Committee on Ethics and Professional Responsibility addresses client due diligence, money laundering, and terrorist financing. It examines the contours of ethical obligations regarding efforts to deter and combat money laundering. The opinion acknowledges that lawyers are not gatekeepers (as FATF would prefer), but has a responsibility to avoid aiding and abetting fraudulent or criminal conduct. It takes the position that attorneys should be knowledgeable of risk-based approaches and should develop guidance for client intake.

Beginning in 2002 the U.K. has implemented the customer due diligence, suspicious activity reporting, and no tipping off obligations for lawyers. Solicitors can go to jail for violating those requirements.

Many U.S. lawyers maintain that the Model Rules of Professional Responsibility include sufficient guidance regarding client due diligence, suspicious activity reporting, and no tipping off obligations. For a summary of the various Model Rules related to client due diligence/know your client, suspicious transaction reporting, and no tipping off, see Item 37.e of the ACTEC 2019 Summer Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

FATF also believes that law enforcement has the unrestricted right to know the owners of every entity or trust, and it has pushed for the public registry of owners of all entities and trusts. This is an ill-conceived proposal; drug lords are not stupid. The requirement of public registries would impose a unfair burden on law-abiding citizens. They have a great potential for abuse; the information would be on a silver platter for the neighborhood hacker.

In FATF's call for more transparency, it gives lip service to the protection of privacy, but its actions give little evidence of actual concern with the protection of privacy.

14. Privacy Under Attack

Privacy is very important for individuals. Unwanted disclosures can not only be embarrassing, but can lead to loss of employment, ridicule, persecution, financial setbacks, and damaged relationships. Duncan's deep involvement with pushing back against FATF's attacks on privacy have heightened his sensitivity to increasing attacks on privacy in our society.

Trends in the tech industry result in enormous data collection, creating privacy concerns. "We are at a perilous moment." The history of this ongoing trend is detailed in "The Age of Surveillance Capitalism: The Fight for a Human Future at the New Frontier of Power" by Shoshana Zuboff. The trend began in the 1990s when Google discovered that data it collected could be used to predict future behavior, and it began monetizing that information to target advertising effectively. Google's revenue rose over a four-year period from $86 million in 2000 to $3.2 billion in 2004. In subsequent years, Facebook, Amazon, and others have followed that playbook and now have enormous surveillance-based revenue streams, with little to keep them from capitalizing on the behaviors futures market.

Governments and politicians similarly use the vast data about individuals. The Snowden revelations highlight that government power can be used to skirt rules that protect the public. The behavior data can predict political leanings; for example, the choice of laundry detergent or music selection can be correlated to political preferences or sexual orientation. Such is the power of Big Data.

The data is used not just to *predict* behavior, but increasingly to *manipulate* behavior. The better a system is in predicting outcomes, the more valuable it is. One way to improve predictions is to design systems that nudge, herd, and guide people toward predetermined outcomes. The system incentivizes mass

manipulation. To urge a specific soft drink is one thing, but to manipulate a person's behavior or compel an individual toward a choice is something else altogether. "If personal behavior is impacted, we are indeed in George Orwell's *1984.*" Mass manipulation may result. For example, Facebook can make decisions that sway the emotions and reactions of its users. Studies have shown that people are much more vulnerable to manipulation that we have previously thought.

15. Possible Actions That Can Be Taken for Privacy Collection

These privacy concerns are increasingly a geopolitical issue. China and the U.S are in a data arms race. There is no simple solution.

a. **Laws.** No single comprehensive law addresses limits on the collection of personal data, but a variety of laws deal with privacy concerns. Federal privacy laws include The Federal Trade Commission Act, The Financial Services Modernization Act, The Health Insurance Portability and Accountability Act ("HIPAA"), Children's Online Privacy Protection Act, The Fair Credit Reporting Act, The Stored Communications Act, The Computer Fraud and Abuse Act, Telephone Consumer Protection Act, and The Video Protection Act.

b. **State Laws.** Some states, such as Alaska and California, have constitutional provisions regarding the right to privacy. Also, some states have legislation about the collection and sale of information collected over the internet. The California statue is the most protective.

c. **European Union.** The European Union has very extensive provisions in the General Data Protection Regulation ("GDPR"), which addresses particularly sensitive data (such as health data). A similar statute is needed in the U.S.

d. **Update Model Rules of Professional Responsibility.** As mentioned above, to assist in resisting the FATF's over-the-top Recommendations regarding attorney activities, the Model Rules should be amended to mandate due diligence and risk assessment for prospective and existing clients to minimize the extent to which attorneys are used to facilitate money laundering or terrorist financing.

e. **ACTEC Support.** Duncan recommends that ACTEC take a role in supporting privacy legislation. "This is an issue for the ages that transcends politics. In the final analysis, what's more important than protecting privacy, protecting our clients' private information, protecting the individual, and protecting our democratic institutions?"

Items 16-20 are observations from a seminar by Kim D. Fetrow, Shaheen I. Imami, and Leiha Macauley, Loose Lips Might Sinks Ships – The Ethics of Disclosures and Testimony by Estate Planners: Tips, Tools and Trade Secrets

16. Attorney-Client Privilege

a. **Rationale of Privilege Doctrine.** The underlying rationale of the attorney-client privilege doctrine is that lawyers can effectively represent clients only if a free flow of information exists between the client and lawyer.

b. **Essential Elements.** Essential elements of the attorney-client privilege are (1) a communication, (2) between a lawyer and her client, (3) related to the rendering of legal advice in the course of the attorney-client relationship, (4) made with the expectation of confidentiality, and (5) the privilege has not otherwise been waived.

c. **Between Client and Attorney; Who Is the Client?** 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).

   (1) **Common Interest Agreement**. In joint representations, consider a common interest agreement if protecting communication is critical to the engagement when communicating with multiple individuals.

(2) **Family Members; Unintentional Waiver**. A client's family members may show up at estate planning conferences. 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 unless the client can establish that their presence is "necessary to assist in the representation." Model Rules of Professional Conduct, Comment to Rule 1.14. 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.

(3) **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.

Consider using a very broad Kovel letter, providing that everything the individual does and all of the individual's work papers belong to the lawyer. That provision protects the client and the third person. The best practice is for the attorney actually to keep the work papers 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 work papers would not be produced.

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

d. **Related to Rendering of Legal Advice.** Not all communications between an attorney and a client are privileged. Noting a memorandum as "privileged" does not make it privileged. Communications with clients about meeting dates, attendance at meetings, etc. are generally not privileged. Also, 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).

Communications between customers and attorneys at investment advisory firms, family offices, and trust companies are generally not privileged if the attorney is not practicing law and rendering legal advice to outside clients. (But an in-house attorney's advice to the attorney's company is privileged.)

e. **Made With Expectation of Confidentiality; Drafts of Documents Intended to be Public.** The privilege would not apply to documents after they have been made public.

Courts differ as to whether drafts of documents are privileged. 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.

f. **Testamentary Exception to Privilege.** Communications between a lawyer and client before the client's death may be discoverable if disclosure after the client's death would help further the client's testamentary intent. The Restatement (Third) of Law Governing Lawyers recognizes this exception even if the personal representative refuses to waive the privilege. §81 comment b. The ACTEC Commentaries take a more limited approach that disclosure is appropriate if the client's personal representative consents or if the decedent "had expressly or impliedly authorized disclosure." Disclosure is "impliedly" authorized if it "would promote the client's estate plan, forestall litigation, preserve assets, and further family understanding of the decedent's intention. Disclosure should ordinarily be limited to information that the lawyer would be required to reveal as a witness." ACTEC COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT, Commentary to Rule 1.6 at 80 (Fifth Edition 2018).

While the attorney-client privilege survives the client's death (*see Swidler & Berlin v. United States,* 524 U.S. 399, 410 (1988)), most believe that privilege passes to the personal representative following the client's death. The rationale of the testamentary exception is to further understanding of the client's intent. *See id.* at 405. Some states require ambiguity to waive the privilege under this exception.

g. **Fiduciary Exception.** The fiduciary exception to the attorney-client privilege recognizes that a communication is not privileged in a proceeding alleging a breach of trust by a fiduciary "if the communication (a) is relevant to the claimed breach; and (b) was between the trustee and a lawyer … who was retained to advise the trustee concerning the administration of the trust." RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS §84 (2000). The beneficiary may argue that the attorney is being paid by the trust for the beneficiary's benefit, so the beneficiary should be able to access any communications between the lawyer and the fiduciary. The fiduciary exception is an interpretation that in certain circumstances, the beneficiary of the fiduciary relationship is the real client. The counterargument is that the purpose of the privilege is to facilitate communications between a lawyer and fiduciary, and that the beneficiary is not necessarily entitled to access those communications. A distinction made in some jurisdictions is whether the communication was intended to protect the fiduciary against a breach of duty claim by beneficiaries (in which case the exception would not apply and the communication would remain privileged). The scope of the fiduciary exception to the attorney-client privilege doctrine varies from jurisdiction to jurisdiction. Having the fiduciary pay individually for legal services about protecting the fiduciary enhances the likelihood that the exception will not apply.

17. Duty of Confidentiality

The lawyer's duty to maintain confidences is an ethical duty. The attorney-client privilege is an evidentiary doctrine, typically defined by statute. Communications subject to the confidentiality restriction are not necessarily privileged in a litigation context.

Rule 1.6 of the Model Rules of Professional Conduct address confidentiality. Violation of the confidentiality ethical standard can give rise to a cause of action.

Model Rule 1.6(a) is the general rule that a lawyer shall not reveal confidences. Model Rule 1.6(b) provides various exceptions, including situations in which the lawyer reasonably believes that disclosure is necessary to prevent reasonably certain death or substantial bodily harm, or to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services.

Rule 1.6 is extremely broad, covering matters related to the representation, including the identity of the client, communications with client advisors, invoices, financial information, and even reactions of the client.

Under certain circumstances, the duty of confidentiality may be waived. Possible waiver situations include informed consent by the client, an express prospective waiver by a client in the event of diminished capacity (for disclosure to an agent, but be wary to make sure that disclosure is in the client's best interest), implied authority (but ethics committees are not keen on implied authority so be very careful relying on it), and express waiver at death (the engagement letter may permit disclosure of information regarding the client's dispositive documents and intent that would promote the client's estate plan, forestall litigation, preserve assets, and further family understanding of the decedent's intention).

In addition, a client's fiduciary may be able to consent to disclosure. In some states, a personal representative may not have the authority to waive the duty of confidentiality even if the personal representative can waive privilege. In other states, the privilege and confidentiality duty are treated the same.

18. Work Product Doctrine

The work product doctrine applies only to certain matters prepared for litigation in progress or in reasonable anticipation of future litigation. Protection under the attorney work product doctrine is held by the lawyer, not the client. It includes tangible or intangible items. Two types of work product include (1) fact work product [such as witness statements, investigative reports, interoffice memoranda, photographs, etc.] and (2) opinion work product [such as mental impressions, conclusions, opinions or legal theories of a party's attorney or other representative concerning litigation].

Opinion work product is always protected, but fact work product may have to be disclosed if the requesting party has a substantial need for the materials to prepare for trial and cannot obtain the substantial equivalent of the materials by other means without undue hardship. *See* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS §§88-89 (2000); FEDERAL RULES OF CIVIL PROCEDURE §26(b)(3)(A)(ii).

The purpose of the work product doctrine is that litigators should be able to prepare their cases without interference from the other side, and lazy lawyers should not merely be able to piggyback on the work of the opposing attorneys. An exception is that if work product is going to be used in a trial, disclosure may be required prior to the trial.

The work product doctrine is broader than the attorney-client privilege in that it can include materials in addition to communications between a lawyer and client.

The most often litigated issue regarding the attorney work product doctrine is whether the product was produced in anticipation of litigation.

Work product protection can be waived, just like the attorney-client privilege. Voluntary disclosure of information can result in a waiver.

Turning over attorney work product may sometimes benefit the client, for example, by reinforcing the estate plan and the client's intent. The disclosure makes clear that the attorney is not trying to hide something. Do not just fall back on the right to withhold attorney work product in all situations.

19. Production Requests

a. **Practice Tip Summary.** "When someone other than the client contacts you (or your staff!) seeking information or documents related to the client's estate plan (and this often happens informally by a quick phone call or email), the initial reaction may be to respond immediately to try to be 'helpful.' **STOP.** Proceed cautiously and after careful consideration of the consequences. Do not respond substantively until you have carefully analyzed whether you have express or implied authority to disclose, whether disclosure would further the representation and the client's interest, what information, short of all, would be responsive to the request, and depending on the circumstances, consulted with your own litigators regarding the attorney-client privilege and related issues regarding potential litigation. The first follow-up call, however, if the client is still living, should be to your own client to verify the facts that have given rise to the request and to obtain his or her express consent (if he or she has capacity)."

b. **Duty to Respond?** Someone who is not a party to litigation has no need to respond to any production requests other than a subpoena or a court order. This is probably true even if directed by the client (or someone who holds the privilege) to disclose certain information. A party to litigation must respond to proper discovery requests.

c. **Ethics of Producing Client File; What Constitutes "Client File" Subject to Turnover?** The majority rule is that the entire file belongs to the client, and the attorney must surrender everything related to the representation unless the attorney establishes an express exception (e.g., attorney work product). The minority rule is that only documents that constitute the end-product belong to the client and must be produced; documents that led to the creation of the end-product need not be produced.

Because protection under the work product doctrine belongs to the attorney and not the client, the attorney generally does not have to turn over work product doctrine even if the client or client's agent/executor waives confidentiality. However, if the client's and attorney's interests do not align, a court might determine that the client's interest prevails and may require disclosure of work product.

d. **Proactive or Voluntary Disclosure – Practice Tips.** The written materials provide very helpful practical tips –

a. Do you even disclose or acknowledge the representation?

b. Just because you can doesn't mean you should: Sometimes, even without prompting, you just might want to "help" by providing your perspective and expertise – resist this temptation because it can get you into hot water. You don't want to go from worrying about a request for your file or testimony, to responding to an ethics complaint or lawsuit for a breach of fiduciary duty to your client. MRPC 1.6. Trust in the process and the applicable rules because they can be your allies.

c. So, only consider being "helpful" when expressly authorized by the holder of the privilege or if you know the privilege was waived; or if you know no privilege or other protection exists. If you're not confident of either, then don't – even if you think it might be helpful (MRPC 1.6). Even if you reasonably believe you're authorized, it might be wise not to venture too far onto a limb without first understanding everything that's at issue and how it might affect you.

d. Can you reasonably rely on the prospective waiver from your client contained in your retainer agreement or subsequent correspondence regarding privileged or confidential communications?

e. Although the protections of the attorney work-product doctrine generally are yours to waive, will a waiver serve your interests or your client's interests? Are your interests aligned or conflicting?

f. Typically, the best response in these situations is a polite, but firm, "No."

Panelists emphasized that the first response should be a polite no, pending careful further consideration. If the client requests the disclosure, the attorney must determine what belongs to the client; only the client's material would be produced, after obtaining an express written consent/CYA letter from the client.

"There's nothing wrong with saying no. I say no all the time to my kids."

20. Testifying as a Witness

a. **Several Preparation Steps.**

- Obtain counsel, and do not automatically select someone from your own firm.
- Make sure you understand the issues involved; review the petition.
- Determine if privilege will be claimed BEFORE the deposition, so the parties won't gather for the deposition for the attorney to merely say that everything is privileged.

b. **Lawyer as Advocate and Witness.** Rule 3.7 of the Model Rules of Professional Conduct address when a lawyer may act as an advocate at a trial in which the lawyer is likely to be a necessary witness. Even if the lawyer is precluded from serving as an advocate, the lawyer could still work on the case outside of court, but such activities must not be revealed to the jury, and such acts could trigger other conflicts rules. ACTEC COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT, Commentary to Rule 3.7 at 187 (Fifth Edition 2018).

c. **Practice Tips.** The written materials have extensive very practical tips for witnesses. The following tips are extracted from those materials.

(1) Listen, listen, listen.

(2) Don't try too hard – if you don't know, that is fine.

(3) Make sure you understand the question.

(4) Take your time (this is standard operating procedure (SOP) and do this for every question; be consistent and disciplined; it does not make you look bad as a witness).

(5) Always remember, you are making a record.

(6) Tell the truth (but just because you are telling the "whole truth" doesn't mean you answer more than the question actually asked).

(7) Be relentlessly polite while remaining in control (keep your cool; do not make it personal).

(8) Give the shortest answer necessary to make sure the record reflects what you really mean without ambiguity.

(9) Remember your core facts and positions.

(10) Don't answer a question you don't understand.

(11) Do not guess or speculate.

(12) Don't volunteer.

(13) Be careful with documents and prior statements; ask to see the document and read it before answering the question; (ask to have the question repeated after you have read the document).

(14) Use your counsel – give your attorney time to make objections and listen closely to the objection.

Items 21-30 are observations from a seminar by Lyat Eyal, Michelle B. Graham, Patrick Francis Harney, and Kevin E. Packman, Thinking of Naming a Foreign Person as a Fiduciary? Think Twice. Beneficiaries Living Abroad? Check Thrice. Advising Clients Who Want to Name a Foreign Individual as Fiduciary of their Estate Plan or when a Beneficiary Resides Abroad

21. Seek Advice from Attorney in Foreign Country

When dealing with a foreign person as a client or even as a trust beneficiary, seek advice from an attorney in the relevant country. Rule 1.1 of the Model Rules of Professional Responsibility provides that a lawyer shall provide competent representation, which requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

A person that owns assets in multiple countries should have local advice from each jurisdiction and should make sure that somebody has the authority to manage assets in each country.

22. Basic Differences Between Common Law and Civil Law Countries

a. **Trusts.** Common law countries recognize trusts and civil countries generally do not. Accordingly, a plan with a pourover will to a revocable trust may not work for assets or beneficiaries in that country.

b. **Freedom of Disposition.** Common law countries uphold the freedom of testamentary disposition, but limits apply in civil law countries because they typically have forced heirship laws requiring that a certain portion of the estate (up to two-thirds) passes to children of the decedent.

c. **Administration.** In common law countries, the estate vests in a personal representative who administers the estate. In civil law countries, the estate vests directly in heirs and legatees. The identity of the heirs are evidenced by "notarial act," and the heirs take the assets subject to liabilities. There is not an executor responsible for paying debts and taxes and having the authority to marshal assets.

d. **Matrimonial Regime.** Common law countries typically have no matrimonial regime that provides a certain minimal amount to spouses, but community property countries provide that the spouse owns 50% of assets that are acquired during the marriage. Civil law countries typically have a matrimonial regime protecting the rights of spouses.

   Observation: Civil law countries do not recognize trusts, have forced heirship, and provide that half the assets are owned by one's spouse. That may leave a small amount that the estate planner is left to work with.

e. **Tax Systems.** In the United States, an estate tax applies, and the executor is responsible for paying the estate tax. Civil law countries typically have inheritance tax systems, and the beneficiaries are responsible for paying the tax. The tax treaty will indicate if a foreign tax credit applies. Confusion may result if trusts are used in a country that does not recognize trusts, and a higher rate may apply.

23. What Law Applies

a. **Significance.** The applicable law will affect judicial jurisdiction, characterization of property, disposition of property, and the recognition of the enforcement of foreign judgments.

b. **Law Selected in Testamentary Documents.** In the United States, courts generally uphold the choice of law selection in the testamentary document, but some foreign countries may not recognize that choice.

c. **What Law Applies If No Governing Law Is Specified?** In common law countries, the law of the jurisdiction of domicile applies as to personal property and the law of the situs governs as to real property. In contrast, in civil law countries the law of the country of nationality (generally where the person is a citizen) governs.

A European Union regulation, known as Brussels IV, has been adopted in the EU countries other than the U.K., Ireland, and Denmark. The general rule is that the governing law in which the deceased was "habitually resident" controls with respect to the succession of property. However, persons having a nationality (i.e., citizenship) different from the place of their last habitual residence have the option to choose the law of their nationality to apply to their succession. For example, a U.S. citizen could provide in the will that the law of their nationality (i.e., the U.S.) will apply for succession issues rather than the law of the last habitual residence. **In this manner, the forced heirship provisions generally applicable in the E.U. could be avoided by U.S. citizens with ties to or who have property in the E.U**. Accordingly, the E.U. regulation impacts Americans with property in the E.U. even though the United States is not a participant in the regulation. For a more detailed discussion of Brussels IV, see Item 36 of the ACTEC 2015 Summer Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

The Hague Convention on the Law Applicable to Succession to the Estate of Deceased Persons attempts a similar approach but it has only three signatories and is not yet in force.

24. Will a Foreign Country Recognize the Validity of a Will?

a. **Hague Convention on the Conflict of Laws Relating to the Form of Testamentary Dispositions of 1961.** The form of a testamentary disposition is valid if the form complies with the law of the place of execution, the testator's nationality, the testator's domicile, the testator's habitual residence, or, as to immovables, where they are located. About 40 countries have ratified this convention, but not the United States.

b. **Washington Convention.** The Washington Convention established a uniform law on formalities of an international will without invalidating or superseding the laws of other countries. Less than 15 countries have ratified the Convention, including the United States. About 15 states (including California) in the United States have adopted the Convention.

c. **Validity of Provisions in Will.** Just because a country recognizes the validity of a will does not mean the country will recognize all of the provisions in the will. For example, if a will leaves everything to a surviving spouse, a foreign country may still apply its forced heirship provisions for assets that must pass to children. Also, a foreign country may not accept the person named as executor in the will as having authority in that foreign country.

Foreign countries typically do not prohibit naming a guardian in a will, but a foreign country may not respect that children living in the foreign country would have to move back to the United States to live with the guardian. That may be a facts and circumstances test, for example depending on how long the child has lived in the foreign country. Every country has different requirements as to who is qualified to be a guardian.

25. Trust Issues; Choice of Law; Unintended Consequences

a. **Not Recognized in Civil Law Countries.** Trusts are generally not recognized in civil law countries, but a few have codified trust laws (e.g., Japan and South Africa).

b. **Choice of Law for Trusts in United States.** United States courts generally look to the governing law selected in the trust instrument. Section 107 of the Uniform Trust Code allows a settlor wide discretion in selecting the law governing the trust.

> SECTION 107. GOVERNING LAW. The meaning and effect of the terms of a trust are determined by:
>
> (1) the law of the jurisdiction designated in the terms 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; or
>
> (2) in the absence of a controlling designation in the terms of the trust, the laws of the jurisdiction having the most significant relationship to the matter at issue.

This statutory provision leaves significant uncertainties in its application to any particular situation. A comment to the Code specifically recognizes the difficulty of formulating any specific rules and states that "[t]his section does not attempt to specify the strong public policies sufficient to invalidate a settlor's choice of governing law. These public policies will vary depending upon the locale and may change over time."

Thirty of the 35 jurisdictions that have enacted the UTC have enacted some form of §107. Fourteen jurisdictions have made substantive changes. These provisions are summarized in Tom Gallanis, *The Use and Abuse of Governing-Law Clauses in Trusts: What Should the New Restatement Say?*, 103 IOWA L. REV. 1711 (May 2018).

c. **Trust Silent Regarding Governing Law.** If the trust does not address the governing law, courts look to the jurisdiction that is most significantly related to the trust considering a variety of factors, including the location of assets (especially for real estate), place of administration, trustee's place of business, place of execution, and settlor's domicile.

d. **Unintended Consequences.** Even if trusts are recognized, surprising effects may result in some countries. Examples: Canada applies a deemed disposition every 21 years; countries with an inheritance tax may treat a trust as an "unrelated party" resulting in higher rates and smaller exemptions.

26. United Kingdom Tax Issues With Trusts

Ironically, the country that invented trusts clamped down on the use of trusts with tax law changes in 2006. A trust created after March 22, 2006 that is subject to the U.K. tax rules (see below), even if created by a United States person, is subject to a 20% tax on the value over £325,000, a 6% tax on the value of the trust every ten years, and 6% charge on exit (prorated from when the last ten-year tax applied).

The U.K. tax applies if the trust is domiciled or deemed domiciled in the U.K. or to the extent of U.K. assets in the trust.

A United States person creating a revocable trust with U.K. assets may even be subject to the tax, and the assets may be in the person's estate for inheritance tax purposes under a §2036 equivalent. In some situations, though, the revocable trust may be treated as a "bare trust" that is not a true trust but something like a nominee arrangement that is not subject to the U.K. tax on trusts.

27. "Foreign Trusts" For U.S. Tax Purposes

a. **General Rule.** A trust is a foreign trust under §7701(a)(31) unless a court in the United States exercises primary supervision over the administration of the trust (the "Court Test"), and one or more United States persons have authority to control all substantial decisions of the trust (the "Control Test"). One effect of being a foreign trust is that a transfer of appreciated property to the foreign trust by a United States person is treated as a deemed sale of the underlying assets for fair market value (unless the transfer is to a grantor trust).

b. **Substantial Decisions Under the Control Test.** Regulations treat the following as substantial decisions for purposes of the Control Test (but this is not an exhaustive list): whether and when to distribute income or corpus; the amount of any distributions; the selection of a beneficiary; whether a receipt is allocable to income or principal; whether to terminate a trust; whether to compromise claims; whether to sue on behalf of or defend the trust; whether to remove, add, or replace a trustee; whether to appoint a successor trustee (unless limited so that it cannot be exercised to change the trust's residency); and investment decisions. Treas. Reg. §301.7701-7(d)(1)(ii). Control means the power, by vote or otherwise, to make all substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. Treas. Reg. §301.7701-7(d)(1)(iii).

If an inadvertent change occurs in any person having such a substantial decision (for example, if the successor trustee is a foreign person), the trust is allowed 12 months to make necessary changes with respect to the persons who control substantial decisions or the residence of such persons. Treas. Reg. §301.7701-7(d)(2).

c. **Loans From or Use of Foreign Trust Assets.** A foreign trust generally cannot be a grantor trust, but there are exceptions. If a foreign trust is a grantor trust, the trust beneficiaries are not taxed with respect to distributions from the trust. If the foreign trust is not a grantor trust and a United States beneficiary or the settlor (or someone related to them) receives a loan from the trust or uses trust assets without compensating the trust for such use, the United States recipient is taxed on the value of the loan or such use. Exceptions exist for qualified loans and loans with arms-length terms or if payment is made for the use within a reasonable time. §643(i). Such transactions must be reported on Form 3520.

28. Powers of Attorney; Health Care Directives

Powers of attorney are typically recognized in a foreign country as long as requirements in the jurisdiction are satisfied (the agent is over 18 years of age, has capacity, and meets jurisdictional requirements). Practical considerations include (1) the document should be translated into the foreign language, (2) in some jurisdictions (such as Israel and the Cayman Islands), a court order may be needed, and (3) in some countries (such as the United Kingdom), if the spouse is named as agent, in the event of divorce the power of attorney is void.

Health care directives similarly may theoretically name someone in a foreign country as agent, but that may not be practical for making health care decisions from the foreign country.

The best approach is to prepare powers of attorney and health care directives in the country where the principal lives.

29. Foreign Wills

Issues in Israel provide a good example of why a person should generally have a will to deal specifically with assets in a foreign country. Otherwise, substantial administrative burdens may result. Because of tax issues, Israeli wills are usually very short, often just 2-3 pages. If a person comes to Israel with a 40-page will, in most probate procedures, someone will ask that it be translated into Hebrew. Having a 3-page Israeli will is much simpler. Use an Israeli will that governs only Israeli assets.

30. U.S. Reporting of Foreign Assets

If foreign assets are involved, determine if reporting of foreign assets is required. Possible forms required are–

- **3520,** *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*
- **3520-A,** *Annual Information Return of Foreign Trust With a U.S. Owner*
- **5471,** *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*
- **8621,** *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*

- **8858,** *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs)*
- **8865**, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*
- **8938,** *Statement of Specified Foreign Financial Assets*
- **FinCEN Report 114**, *Report Foreign Bank and Financial Accounts*

Items 31-35 are observations from a seminar by Sarah Moore Johnson, Professor Kristine S. Knaplund, and Joshua S. Rubenstein, When ART and 23andMe® Shake the Family Tree: Updating Estate Plans for Changing Families

31. Assisted Reproduction Technology (ART) Significance; Definitions

a. **Significance.** About 1.7% of all infants born in the United States are conceived using in vitro fertilization (IVF), an infertility treatment in which a mature egg is fertilized by sperm in the laboratory and the resulting embryo is implanted in a woman's uterus. As of 2018, more than 8 million children worldwide have been born from IVF and other advanced fertility treatments.

b. **Definitions.**

- Gametes – reproductive cells (eggs and sperm); by themselves they are not capable of developing into human beings;
- Zygotes – single-cell, fertilized eggs;
- Pre-embryo – 4-8 cell zygote, an embryo in the first 14 days of creation; it may be cryogenically stored and later thawed;
- Embryo – exists at the stage at which cell differentiation develops, it is the prenatal stage of development up to the end of the 8th week of development;
- In vitro fertilization – conception is accomplished by fertilization of an egg with sperm outside the human body;
- In vivo fertilization – conception is accomplished inside the uterus;
- ART – assisted reproductive technologies;
- AID -- artificial insemination by an anonymous donor;
- AIH – artificial insemination by the husband;
- Surrogate – a woman whose own egg is inseminated by ART and will carry the resulting baby to term but who under a surrogacy agreement is not the legal guardian of the child (this is rarely done);
- Gestational carrier – a woman who is implanted with a fertilized egg other than her own, but under a surrogacy agreement she will not become the legal guardian of the child;
- Intended parents – If an ART procedure is successful, the persons who will be the legal guardians of the resulting baby; and
- Dibling – a term referred to by Hugh McGill in his Trachtman lecture in 2018 as children conceived from a common donor; they are half-siblings, or "diblings" for short.

32. DNA Testing

a. **Testing Companies**. The two major DNA testing companies are Ancestry.com (which has been used by 16 million people and grew by 67% from 2018 to 2019) and 23andMe® (which has 10 million customers and customers doubled from 2018 to 2019, its health reports are more robust than those provided by Ancestry.com). Lesser known companies are MyHeritage and Family Tree DNA.

b. **Test Results.** Test results are typically available within three to eight weeks. The results include reports of the user's ethnicity and maps of where the user's ancestors lived with information about those regions. Users may opt-in to a search for relatives, who can message each other through the company's software.

c. **Database Companies**. GEDMatch is not a DNA testing company, but it has an extensive database. Users of DNA testing companies may import their results to generate even more DNA matches. It has been used by law enforcement to solve cases, including the Golden State serial killer case in 2013.

d. **General Effect in Estate Planning Context.** As a result of the dramatic increase in the use of DNA testing, persons increasingly are finding unknown relatives, such as unknown half-siblings (who the parent kept secret from the family) or donor-conceived half-siblings from a common donor under an ART procedure. A host of legal issues arise, as illustrated by the following case study situations.

33. Case Study 1 – Discovery of Half-Siblings from DNA Tests

a. **Case Study 1 Brief Description.** Through DNA testing a client discovered that she had an unknown niece and nephew. The client had no children of her own, but did have other known nieces and nephew from her predeceased brother. Family research uncovered that her mother had an affair with a rodeo mystery man years before her parents had married. The child of the affair was deceased but his two children survived (the unknown niece and nephew).

Alternatively, instead of a rodeo mystery man impregnating the client's mother, consider that the client's deceased full brother had been a sperm donor, resulting in the donor-conceived niece and nephew.

b. **Inheritance Rights.** If the client dies without a will, would the unknown niece and nephew inherit from her? The answer varies in different states.

(1) **Adoption.** If a child was adopted, adoption severs inheritance rights except in limited circumstances (such as step-parent adoptions). UNIF. PROBATE CODE § 2-119. Section 2-116 states that unless an exception applies, the parent-child relationship established under the Code applies for inheritance purposes.

A minority view provides a continuance of inheritance rights between the adopted child and the genetic parents if so stated in the adoption decree. In Kansas, Louisiana, Rhode Island and Texas, an adoption decree terminates the right of the birth parent to inherit from the adopted child, but the adopted child may still inherit from the birth parent. Illinois and Pennsylvania also permit inheritance rights in certain situations.

(2) **Half-Bloods.** If an adoption has not terminated inheritance rights, the majority view is that half-siblings generally have the same inheritance rights as full siblings. UNIF. PROBATE CODE § 2-107 ("relatives of the half blood inherit the same share they would inherit if there were of the whole blood"). Under the UPC, genetic siblings who have never shared the same home or who may not know of each other's existence may still have inheritance rights from each other. A minority of states treat half-siblings less than equal to whole-blood siblings for intestacy purposes.

(3) **"Brother-Sister" Intestacy Statutes.** In several states (e.g., Delaware, Oregon, and Connecticut), the inheritance statutes refer to the inheritance rights of "brothers and sisters" rather than referring to descendants of the decedent's parents. Therefore, limits on the inheritance rights of a parent or child where there is no parent-child relationship would not affect other relationships, such as siblings. Thus, in those states, donor-conceived siblings and unknown genetic half siblings, along with their kindred (such as nieces and nephews) could inherit from one another.

In contrast, most states would recognize sibling relationships only after a parent-child relationship is established. If a parent-child relationship does not exist, because of an adoption or because parental rights have been given up in an assisted reproduction procedure, the resulting children would not be treated as siblings.

(4) **"Genetic Parent" Statutes Generally Prevent Inheritance Between Siblings Unknown to Each Other.** Some states that treat half-bloods the same as whole bloods use a "natural parent" or "genetic parent" definition to establish the parent-child relationship instead of an intent-based definition, but the intestacy statutes in those states generally preclude inheritance rights unless the genetic parent has openly treated the child as his own and has not refused to support the child. (Examples are Alabama, Arizona, California, Idaho, Indiana, Michigan, Montana, South Carolina, South Dakota, Tennessee, and Utah.) In these states, donor-conceived siblings would not inherit from each other because donors would have signed away their parental rights in the contract with the recipient. Unknown half-siblings also would not inherit from one another if their common father had not known of the paternity, or if the common parent had known but kept it a secret or had refused support.

In a few of the genetic parent states (New Jersey and West Virginia), inheritance rights are not affected by the fact that the father did not acknowledge or support the child, and in those states, half-siblings could inherit from one another even if the shared father had never known of the child's existence.

(5) **Intestacy Statutes Updated for ART; 2010 Uniform Probate Code.** The intestacy provisions in the Uniform Probate Code were amended in 2010 to address assisted reproduction parent-child relationships. The amended provisions generally preclude third-party donors from being treated as parents for purposes of intestacy statutes. Genetic parents and children inherit from each other unless the assisted reproduction exceptions or the adoption exception applies. However, the statute does not contain an exception for genetic parents who have refused to openly acknowledge or support the child. Therefore, unknown half-siblings (as opposed to donor-conceived half siblings, who would be precluded from inheriting from each other under the assisted reproduction exception) would inherit from one another, even if the parent had no knowledge of his paternity. States that have adopted these provisions include Colorado, Maine, New Mexico, and North Dakota.

(6) **"Genetic Parent" Statutes Should Retain "Openly Treat as Own" Requirement.** Statutes (such as the amended Uniform Probate Code) that recognize inheritance rights through genetic parents, unless the parental rights have been terminated through adoption, contracts or statutes connected with assisted reproduction technology, or a judicial proceeding should also retain a requirement that the genetic parent openly treat the child as his or her own in order for the parent or the parent's kindred to inherit from or through the out-of-wedlock child.

(7) **AVOID INTESTACY!** To bypass this convoluted mess of the intestacy statutes, avoid intestacy by having a valid will in situations where donor-conceived or unknown half-siblings exist or may likely exist.

c. **Class Gifts.** In Case Study 1, if the client had left her estate to her "nieces and nephew," would the unknown niece and nephew receive an equal share of the estate? That depends on whether this is treated as a class gift or as a gift to the "known" two nieces and nephew. (Indeed the clause refers to "nieces [plural] and nephew.")

If the clause is treated as a class gift, if the unknown niece and nephew are treated as a niece and nephew for inheritance purposes, they would likely be included in the class gift.

The lesson is to be very careful using class gifts. That practice opens up the possibility of surprise class members that may be discovered under DNA testing. If class gifts are used, consider using a vertical component (such as descendants of certain parents or grandparents) rather than just a horizontal reference (such as to siblings, cousins, or nieces and nephews). The statutes referring to the parent-child relationship would then apply.

34. Case Study 2 – Posthumous Child

a. **Case Study 2 Brief Description.** A husband (who had two children by a prior marriage) and wife had five viable embryos created by ART. Two were implanted, resulting in pregnancy with twins. The husband subsequently discovered he had terminal cancer. During the pregnancy, the couple visited the estate planner, and the husband expressed his desire that the wife use the three remaining embryos to have additional children after he died. The husband's revocable trust was drafted to leave his exemption amount to his two adult children by the prior marriage, and to leave the balance of the estate to a Marital Trust, which would pass at the wife's subsequent death to the descendants of the husband and wife, regardless whether they were conceived prior to or after the husband's death. (The clause referred to "any child of mine and my spouse that is (i) conceived from my genetic materials and (ii) born during the lifetime of my spouse, even if such child is conceived after my death.") Also, an insurance trust left assets at the husband's death to his "then-living issue, per stirpes."

   The wife conceived a new child using one of the embryos after the husband's death. The husband's two adult children take the position that (i) the wife had no right to conceive the new child after the husband's death, and failing that, (ii) the new child is not a beneficiary of the insurance trust because she was not living at the husband's death.

b. **Right of Wife to Use Embryo After Husband's Death.** Embryos are neither property nor a person. Rights to embryos are governed under contract rights, not as a person or property. If the ART contract does not address posthumous use of embryos, the general trend of cases is to favor whoever does not want to procreate. (The rationale is that the person who wants to procreate has other options, such as adoption or further ART procedures.) In this case, the husband's will was clear that he wanted the embryos to be used, but that would not override language in the contract.

   Planning Pointer: When representing clients who have undergone ART procedures, the planner must get a copy of the ART contract to determine rights of the parties.

c. **Validity of Bequest of Embryos?** If the husband had bequeathed the embryos to the wife, would that bequest have been recognized? No, the embryos (or more technically, pre-embryos, because it is pre-embryos that are frozen and later implanted) are not property and cannot be bequeathed, even though they have commercial value.

d. **Recognition of Posthumous Child as Beneficiary of Trust Under Father's Will.** The Uniform Probate Code was amended in 2008 to included provisions dealing with assisted reproduction. A posthumously conceived child will be considered "in gestation" at the deceased parent's death if that child is in utero within 36 months after the parent's death or is born no later than 45 months after the parent's death. UNIF. PROBATE CODE § 2-120 (2008). (Those provisions were adopted in Colorado and North Dakota in 2009 and bills were introduced in Minnesota and New Mexico in 2009.)

   In Case Study 2, the bequest to the descendants of the husband and wife in the Marital Trust would be recognized. The will was drafted very clearly and expressly contemplated conception after the husband's death. (Observe, however, that conception actually occurred prior to death. This is distinguished from a clear case of post-death conception in which cryopreserved sperm is implanted after death.)

e. **Recognition of Posthumous Child as Beneficiary of Pre-Existing Trust.** In Case Study 2, will the new child be recognized as issue of husband for purposes of the life insurance trust that was completed years previously?

A starting point is to look at whether the new child would be entitled to inherit from the husband under the intestacy statutes. The Uniform Parentage Act (UPA) adopted in 2002 and amended in 2017 addresses the intestacy rights of posthumous children. In order for a decedent to be recognized as parent of a posthumous child, the 2017 version requires (i) written consent by the decedent in a record or by clear and convincing evidence and (ii) implantation of the embryo with 36 months of death or birth within 45 months. UNIF. PARENTAGE ACT § 708(b). Unlike the 2002 version, the 2017 version does not require a marital relationship between the deceased parent and the surviving intended parent.

The UPA establishes the ability of the husband of the sperm receiver to be deemed the resulting child's father, and if the sperm recipient's husband is established as the father, the biological father's ties are severed. The UPA creates a presumption that a child born to a woman who was married to the decedent within 300 days of when the marriage ended by the decedent's death, is the decedent's issue. UNIF. PARENTAGE ACT §204(a)(1)(B).

The 2002 version of the UPA has been adopted in Alabama, Delaware, Illinois, Maine, New Mexico, North Dakota, Oklahoma, Texas, Utah, and Wyoming. The 2017 version has been adopted in Vermont, Washington, and California.

In Case Study 2, the posthumous new child would be recognized as the child of the decedent under the UPA provisions. (That would not be the case if the embryo was not implanted within 36 months or if birth did not occur within 45 months of the decedent's death.)

That is not the end of the analysis, however. These types of statutes dealing with ART issues are relatively recent. When the life insurance trust was created decades ago, it is very unlikely that the husband intended to include posthumously conceived children as his "issue."

Another wrinkle is that older forms often made reference to descendants being "legitimate" in order to be considered as "issue." If the embryo is not implanted for several years, the new child would not be "legitimate."

f. **Rule Against Perpetuities.** Does the possibility of including posthumously children as trust beneficiaries cause a trust to violate the rule against perpetuities? This depends on whether the embryo is treated as a life "in being," and that could depend on the relevant state law, but generally the rule against perpetuities is not violated. As indicated in subparagraph d above, under the Uniform Probate Code, a posthumously conceived child will be considered "in gestation" at the deceased parent's death if that child is in utero within 36 months or is born within 45 months after the decedent's death.

The Uniform Statutory Rule Against Perpetuities adopts a 90-year "wait and see" approach. For a discussion of reproductive technologies and the Rule Against Perpetuities see Les A. McCrimmon, *Gametes, Embryos and the Life in Being: The Impact of Reproductive Technology on the Rule Against Perpetuities*, 34 REAL PROP. PROB. & TR. J. 697 (2000) (discusses the arguments for and against recognition of the embryo as a life in being, as well as suggestions for legislative solutions to this issue). *See also* Sharona Hoffman and Andrew P. Morriss, *Birth After Death: Perpetuities And The New Reproductive Technologies*, 38 GA. L. REV. 575 (2004).

g. **Social Security Benefits.** Is a posthumously procreated child entitled to receive Social Security benefits based on the decedent's benefits? The U.S. Supreme Court ruled that children conceived and born after the father's death were not entitled to receive Social Security benefits where they could not inherit from the father under the state intestacy statute. *Astrue v. Capato*, 132 S. Ct. 2021 (2012). In Uniform Probate Code and UPA states, the posthumously procreated child generally could inherit, and therefore could receive Social Security benefits.

h. **Pretermitted Child Laws.** Many states have pretermitted child statutes making certain provisions for after-born children. Would those statues apply even if an after-born child is not procreated for many years later using ART procedures? Some state statutes have addressed that situation. Some states that adopted the UPC, with its provisions for posthumously procreated children, did not change their pretermitted child statute to address the long-after-born/ART child situation.

35. Case Study 3 – Surrogate Situation

a. **Case Study 3 Brief Description.** Willow and Henry are happily married with two children. Willow's nephew, Sam, is a gay man and is married to Stuart. Sam and Stuart want children. Willow agrees to be implanted with Stuart's sperm though IVF, so the offspring will have genes of both Sam (via his aunt) and Stuart.

Willow, Henry, Sam, and Stuart sign a surrogacy contract, which provides that Willow would deliver the baby in Connecticut, where a pre-birth order would be obtained declaring that Sam and Stuart will be recorded as "Parent and Parent" on the birth certificate, and that Willow would have no legal parental rights (even though she will be the biological mother). A standard surrogacy contract was used that inadvertently prohibited Willow from visiting the child and prohibited the child from inheriting from Willow. The contract prohibited Willow from leaving Connecticut during her last trimester of pregnancy.

Willow was excited to be an "auntie-mommy" and named the future niece or nephew as beneficiary of her $500,000 IRA. Because she could not yet know the child's name, she named "children of Sam, in equal shares."

Shortly before the delivery date, Willow made a quick jaunt into New York to buy fabric for a nursery where the baby could stay when Willow needed to babysit. While in New York, Willow was in a serious auto accident; the baby girl (who was named Grace) was saved, but Willow died in New York.

Because New York does not recognize surrogacy contracts, Willow and Henry were listed as parents of Grace.

Sam and Stuart were angry that Willow left Connecticut in violation of the contract, because they would be forced to incur expenses to adopt the baby girl. To make matters worse, Henry was having second thoughts about allowing the adoption.

Stuart's grandparents had created a Dynasty Trust 35 years earlier providing for "lawful descendants related by blood, specifically excluding adopted children."

b. **Analysis by Prof. Kris Knaplund.** Prof. Kris Knaplund provided a complete yet still concise analysis of various legal issues raised in this Case Study. With her permission, I have quoted her analysis verbatim below.

c. **Recognition of Child as "Children of Sam" under IRA Beneficiary Designation.**

Question 1. Will the baby girl, Grace, inherit Willow's IRA?

The primary beneficiary is "the children of Sam, in equal shares." If Sam adopts Grace, then she would be Sam's child and qualify for the IRA. While the common law excluded adoptees from various class terms, Connecticut reversed this presumption by statute in 1959 in Public Act No. 106, the predecessor to Conn. Gen. Stat. 45-731, for instruments executed after October 1, 1959.

Since Willow is domiciled in Connecticut, we will assume the IRA is in Connecticut. Does Henry have some claim to it? In California he certainly would. Sam and Stuart may well end up adopting Grace despite Connecticut's pre-birth order. New York did not recognize the pre-birth order, and entered Willow and her husband Henry as the parents on the birth certificate. NY has jurisdiction because Grace was born in NY, where surrogacy contracts are contrary to public policy and thus void and unenforceable. N.Y. Code Sec. 8-122. Under NY law the woman who gives birth is the mother, so Willow was listed as her mother on the birth certificate, and her husband Henry as the father.

A NY court accepted an out-of-state pre-birth order in *Matter of Doe*, 793 N.Y.S. 2d 878 (2005), but the twins in that case were born in California and the pre-birth order declaring the intended parents (and not the surrogate) to be the children's parents was issued in California. This situation is quite different: we already have a NY birth certificate naming Willow and Henry as the parents.

Although surrogacy contracts are void in NY, they will not prevent adoption of the child by the intended parents so long as it does not involve enforcing the surrogacy contract. In *Matter of J.J.*, 984 N.Y.S. 2d 841 (2014), the gestational surrogate had relinquished her rights to the child. As long as Henry is willing to relinquish any parental rights he has, NY would allow the adoption if it is in the best interests of the child. If Henry is not willing to relinquish his parental rights, Sam and Stuart can't insist on his doing so pursuant to the surrogacy contract. NY will also look beyond the waiver of parental rights in the donor agreement to see if the parties intended otherwise. *Tripp v.*

Hinckley, 736 N.Y.S.2d 506 (3d Dept 2002). There is evidence here that at least Willow intended otherwise: she certainly didn't intend to waive her rights to visit the child since she was designing a nursery in her home, and she designated a substantial sum for the baby. Still, that isn't inconsistent with her no longer being a parent. And there's no indication pre-contract that Henry wanted to retain parental rights.

Sam and Stuart might see Connecticut as a friendlier forum, and go there to assert parental rights. Connecticut allows traditional surrogacy as here, where Willow used her own egg, but will not grant a pre-birth order for one. Creative Family Connections, **https://www.creativefamilyconnections.com/us-surrogacy-law-map/connecticut/.** Sam and Stuart might be able to get a post-birth order, or they might need to adopt. As in New York, the fact that Willow agreed in the surrogacy contract that she would have no legal rights to the child is not the end of the matter. A Connecticut statute states, "An identified or anonymous donor of sperm or eggs used in A.I.D., or any person claiming by or through such donor, shall not have any right or interest in any child born as a result of A.I.D." Conn. Gen. Stat. Sec. 45a-775. Still, Connecticut is willing to look beyond waivers of rights in donor agreements and the donor statute to see if the parties intended otherwise. *See, e.g., Browne v. D'Alleva*, 2007 Conn. Super. LEXIS 3250 (unreported).

Henry is now having second thoughts about the adoption, so it is not clear he will consent. If Sam and Stuart bring their action in NY, the standard will be the best interests of the child. If they bring their action in Connecticut, the court is more likely to take into account the pre-birth order, and grant either a post-birth order or an adoption. Either way, if Sam is named as her parent either through adoption or the post-birth order, Grace would be the beneficiary of Willow's IRA.

If Sam does not adopt Grace, then we have a conflict between the birth certificate, which states that Willow is the mother, and the surrogacy agreement, which prohibits Grace from inheriting from Willow. Grace could qualify as the contingent beneficiary based on the birth certificate. Technically she is not "inheriting" from Willow since this is a non-probate transfer. "Inheriting" applies only to a probate transfer: a will or intestacy.

d. **Inheritance Rights of ART Child from Surrogate Mother.**

Question 2. If Willow has no will, will her other children share their intestate share of the estate with baby Grace?

The answer probably turns on whether Sam and Stuart adopt Grace. If Sam and Stuart adopt Grace, Connecticut law declares that they are her parents with all the rights of inheritance from and through and each. With a few exceptions not applicable here, the relationship with her genetic parent, Willow, is severed, and Grace would not inherit in intestacy from her. Conn. Gen. Stat. Sec. 45a-775(5). If Henry is successful is blocking her adoption, then presumably she would inherit.

e. **Recognition of Child as Beneficiary of Decades-Old Trust That Excluded Adopted Children.**

Question 3. If Grace is adopted, will that bar her as a beneficiary of Stuart's family's Multi-Generational Trust? Probably not.

Here we have a classic illustration of how trust law has not caught up with science. Clearly Stuart's grandparents meant to exclude only adopted persons who were not genetically related to them when they provided for their "lawful descendants related by blood, specifically excluding adopted children." Because Grace was conceived with Stuart's sperm, she is genetically related to Stuart and his grandparents, even if Stuart winds up adopting her. Courts routinely look beyond the technical words such as "excluding adopted children" to ensure that the settlors' intent is carried out. For specific examples, see Kristine S. Knaplund, *Adoptions Shall Not Be Recognized: The Unintended Consequences for Dynasty Trusts*, 7 UC Irvine L.Rev. 545 (December 2017).

f. **Recognition of ART Child as "Descendant" of Decades-Old Trust.**

Question 4. Now assume the Multi-Generational Trust provided for "lawful descendants," but did not expressly prohibit adoption. [Also assume the fertility doctor mixed his own sperm with that of Stuart to increase the chances of success and that the fertility doctor is the genetic father.] Grace is genetically related to the fertility doctor, not Stuart. Is she a beneficiary?

If we assume Stuart adopts Grace, the issue becomes whether the common law presumption excluding adopted children is applicable to the trust. Since the trust was created in 1983, and Connecticut reversed the common law presumption in 1959, if this is a trust subject to CT jurisdiction, then Grace would be presumptively included.

What if the trust was created in a jurisdiction other than Connecticut? Very few states, if any, still follow the common law presumption for a trust created in 1983. If they do, Grace could argue that applying the presumption to her violates public policy for the reasons discussed in my materials: the presumption singles out children like her who have two parents of the same sex.

g. **Liability for Violating Surrogacy Contract.**

Question 5. If Sam and Stuart must adopt or get a post-birth order, can they sue Willow's estate for the cost difference between that and a pre-birth order?

The surrogacy agreement included a travel ban while Willow was in her last trimester. Such clauses are typical in these contracts to avoid precisely this dilemma: the surrogate giving birth in a state that does not recognize the contract. While the U.S. Supreme Court has upheld a right to travel in cases such as *Saenz v. Roe*, 526 U.S. 489 (1999), and held that it is "assertible against private interference as well as governmental action," it is unlikely that this contract provision would be found to violate public policy and thus is probably enforceable. If the prebirth order was correctly issued, then an appropriate measure of damages would seem to be the difference between the cost of the pre-birth order and the cost of adoption (or post-birth order, if they can get one). In addition, cases have allowed damages for mental suffering and emotional distress if "the breach is of such a kind that serious emotional disturbance is a likely result." Res.2d Contracts Sec. 353. *See, e.g., Guerrera v. Cunningham*, 2015 Conn. Super LEXIS 581 (2015); *Thompson v. Massucco*, 2016 Conn. Super. LEXIS 323 (2016). The express object of this clause in the contract was to prevent precisely what happened: the emotional and financial turmoil caused by her giving birth in New York.

Items 36-44 are observations from a seminar by Louis S. Harrison, Michaelle D. Rafferty, and M. Allison Taylor, Lawyer Well-Being– Forrest Gump and the Practice of Law: Did you know that Stress Reducing Techniques for Lawyers are also Life Enhancing Strategies? (Substance Abuse/Mental Health/Ethics)

36. Significance of Well Being and Stress Reducing Techniques

A report from the ABA Commission on Lawyer Assistance Programs and Hazeldon Betty Ford Foundation reported that 68% of lawyers are unhappy and that 40% are likely or very likely to leave their current position. A report of the National Task Force on Lawyer Well-Being, under the aegis of the ABA Commission on Lawyer Assistance Programs found that between 21% and 36% of lawyers qualify as problem drinkers and approximately 28%, 19%, and 23% are struggling with some level of depression, anxiety, and stress, respectively.

Caregivers have a high degree of burnout (and lawyers are their clients' caregivers), citing issues including conflicting demands on time, lack of control and privacy, lack of social/down time, unreasonable demands, unreasonable expectations, constantly feeling overwhelmed, no sign of relief ahead, increasing complexity of work, and isolation.

Unwell lawyers increase the risk of malpractice and bar complaints. Ethics complaints against lawyers are at the highest levels ever, and 40-70% of disciplinary proceedings relate to substance abuse/depression. The Nevada bar has reported that 60% or more of bar complaints involves some sort of lawyer unhappiness (such as depression).

37. Immediate Techniques to Deal With Stressful Situations

- Mini-meditation ([1] Pause, stop what you are doing, [2] Focus on deep breathing, [3] Pull your shoulders back, [4] Resettle)
- Short walk/nap/ closing of eyes
- Change of location
- Stretch/exercise (short burst, see Item 38 below)
- Move away from the computer screen
- Change vantage point (stand if sitting, sit if standing, walk down the hall, walk around the desk and sit in a client chair)
- Relax (relax jaw, release tongue from roof of mouth, drop shoulders)

38. Dealing With Habitual Stress

"We are the generation that worked really hard – to get to a position that we can work really harder."

Stress is good; it allows us to succeed. These are ideas to help in managing that stress.

- Nutrition; don't skip lunch; take nutrition breaks for healthy snacks such as veggies, fruit, nuts, raisins.
- Bring healthy snacks, meals to the office; this will lead to healthier choices.
- Avoid sugar including sugary beverages; sugar provides no sustainable energy. In the short term, sugar causes blood sugar to spike but an hour later the person feels worse than before. Longer term, continual increased sugar intake activates the aging process and the brain functions less clearly at an earlier age.
- Drink water.
- Physical activity. The following is a way to provide a short burst of physical activity: stand, raise hands, stretch up as high as possible, put hands by side, roll shoulders forward, roll shoulders backward. See item 42 below for further discussion of physical activity.
- Take a day occasionally to work out of the office.
- Restructuring weekends – take a day off midweek and catch up on Saturday (when there are fewer distractions in the office).
- Organization/scheduling/client management (these issues are discussed below).
- Short vacations (2-4 day get away).
- Don't obsess about quick email responses; one alternative is a quick "Got it," or "Received," or "Back to you tomorrow [or next week]."

39. Work to Live

a. **Regain Control of Nights and Weekends.**

- **"Hershey Rule."** Lou Harrison described his "Hershey Rule." If a Hershey bar is in front of him, it will be gone. Phones and computers are Hershey bars of the modern age. "If they are in front of me, I will look. I can't help myself."
- **"Backpack Rule."** If Lou decides not to do further work over a night or weekend, he leaves his files in his backpack and puts the backpack in the closet, and it stays there.

b. **Three-Day Weekends.** At the beginning of the year, block off one Monday or Friday each month. That uses 12 vacation days, but yields 12 mini-vacations. If you don't block off the days, the three-day weekends won't happen.

c. **Take More Vacations.** Similarly, block time for vacations. Take longer vacations (1-3 weeks. During vacations, commit to no work obligations.

40. Multi-Tasking

a. **Debunking Myths.** Myths are that we can multi-task successfully, that it makes us more efficient and productive, that women are especially good at it (they may do it more but they don't necessarily do it better), and that age and experience enable successful multi-tasking (instead, the cognitive ability to do multiple things at the same time actually reduces with age).

b. **Switch Tasking.** Multi-tasking is actually switch tasking. Various neuroscience studies have confirmed that multi-tasking is physiologically impossible for the human brain. The prefrontal vortex (left front) of the brain cannot handle multiple things at the same time. The frontal lobes act as a filter of external information, acting as a filter to what is allowed in, one piece at a time. So multi-tasking is actually switching between tasks, each of which is handled by the brain separately at any given time.

c. **Risks of Multi-Tasking.**

Less Efficient. Rapidly switching between tasks is less efficient. The brain can be compared to an energy efficient LED light bulb. It takes time to warm up, and if switched off early, never fully lights up to its full capacity. It needs time to warm and act to full capacity, which is impossible in a multi-tasking environment. For example, when switching from a calculation project to a writing project, the brain must turn off the math rules processes and activate the language rules processes. The time it takes for the brain to switch processes and engage different cognitive rules takes time and leads to inefficiency.

Memory. Multi-tasking reduces short term memory. (For example, you can't remember where you in the drafting project.)

Anxiety. Multi-tasking increases anxiety about completing projects (and may even lead to depression).

Priorities. Multi-tasking leads to focusing on inappropriate tasks.

Creativity. Multi-tasking inhibits creativity.

IQ. A study by the University of London found that participants who multi-tasked during cognitive tasks experienced an IQ score decline similar to those who stayed up all night.

Mistakes. Multi-tasking leads to a significantly higher probability of mistakes.

d. **Tools to Stop Habitual Multi-Tasking.**

Focus Time. Establish a daily schedule for "focused time" vs. switch task time.

Bursts. Establish daily email "bursts" at structured times.

Block. Block distracting pop-ups.

Alternate. Alternate a "focused time" with a "purposeful pause."

Optimize. Optimize focused time with DND on the phone, hold calls, close the door, work out of the office if helpful during structured focused times.

Time Blocking. Block time on the calendar for particular projects.

Block Out "Focus Days." One panelist routinely blocks Wednesdays from appointments. The day is a focus day for completing projects.

First Hour. Start the day with one hour of computer and productive time. For many, mornings are the most productive time; Lou Harrison quips "my billing rate late in the day should be about 24 cents an hour."

Post-Meeting. After meetings, don't immediately check email, but prepare a follow-up memo for the meeting. Schedule 30 minutes after meetings to formalize notes from the meeting.

41. Greatest Cause of Stress—Bad Clients

Lou Harrison's 90-10 rule is that 10% of his clients cause 90% of his aggravation. His partner once told him, "the practice of law would be so awesome without clients." Lou presented the visual of pouring a small amount of coffee (representing one bad project) into a glass pitcher with clear water. The entire pitcher is muddied and when more clear water is added (a new good project), the pitcher is still muddied. The bad project toxifies the whole workload. Be wary of accepting bad clients or bad projects.

42. Physical Activity

a. **Significance.** Lawyers often fail to prioritize physical activity. Studies demonstrate that exercise improves brain cognition. The lack of exercise can lead to poor cardio health, diabetes, cancer, depression, loss of brain function, increased risk of dementia, and an increased rate of progression of Alzheimer's disease.

b. **Recommended Exercise.** The Centers for Disease Control and Prevention (CDC) recommends 150 minutes of moderate physical activity per week plus a couple of times a week of strength training. If the intensity is increased, the 150 minute recommendation drops to 75 minutes.

c. **Sedentary Lifestyle; Sitting.** Numerous studies demonstrate that a sedentary lifestyle is not offset by exercise. Even if someone gets 150 minutes of exercise per week but sits 10 hours a day (the average office worker), the exercise does not offset the increased mortality risk of the sedentary lifestyle. The risk is intensified if the rest of our lives outside the office is also sedentary.

   Experts say you should start standing at work for at least two hours a day, and work your way toward four.

   Metabolism slows down 90 percent after 30 minutes of sitting. The enzymes that move the bad fat from your arteries to your muscles, where it can be burned off, slow down. The muscles in the lower body are turned off. After two hours, good cholesterol drops 20 percent.

d. **Ideas for the Office to Increase Activity and Reduce Sitting Time.** Bike or walk to work. Stand during your commute. Park further away. Walk stairs rather than using the elevator. Sit on an exercise ball (which engages abdominal muscles). Use a standing desk (you actually have to raise the desk for it to be helpful). Set reminders to take breaks. Set a goal of 250 steps per hour. Conduct standing or walking meetings (that takes a while to get used to). Stand during meetings even if others are sitting. Stand while eating. Stand and walk while talking on the phone. Take lunch outside. Clean desk/office while standing. Use waiting time wisely (get up and move). Get up and stretch when you feel stiff. Drink lots of water (you have to get up to get the water and you have to get up to go to the restroom); when low on energy, drink a glass of water. Walk to colleagues' offices for face-to-face visits.

e. **Office Exercises.** (1) Push-ups (on the floor, wall or table.) (2) Squats (feet one foot apart, hips go behind, knees not beyond toes, chest is up). (3) Planks (either shoulder plank or elbow plank). (4) "Swimming" in place motion with wide arms. (5) Crunches. (6) Bridge (lay down and raise hips from floor). These are exercises that can be done without sweating and the need for a shower, and they take only 5-10 minutes.

43. Sleep

The Virginia Bar has identified the lack of sleep as a physical risk. The more your move, the better you can sleep. Don't do work up until the time you go to sleep. Sleep earlier and more often. Going to bed earlier probably means more sleep and tends to allow you to wake up earlier and adding a mere 15 minutes in the morning can be a significant factor in a more organized and relaxed start to the day.

44. Top Ten Takeways

(1) Deep breathing and posture changes can be immediate stress reducers.

(2) Stand when talking and when working.

(3) The 5 top exercises you can do each and every day.

(4) Restructuring nights and weekends, technology breaks and otherwise.

(5) Vacate(ion) Rest.

(6) Multi-tasking avoidance – eliminate the frantic, scattered activities and focus on one thing at a time.

(7) Set your bandwidth during the day/week/month/year.

(8) Be efficient.

(9) Manage client selection and de-selection.

(10) Do at least 1 thing every day for yourself!

Items 45-57 are observations from a seminar by Natalie B. Choate and Steven E. Trytten, Retirement and Estate Planning after the SECURE Act

45. Brief Summary of Minimum Distribution Changes Under SECURE Act

Section 401(a)(9) of the Code contains the provisions about required distributions from qualified retirement plans (including IRAs). The SECURE Act adds a new §401(a)(9)(H), which includes six subparagraphs.

- (i) and (ii) – **10-Year Rule for DBs, Except for EDBs.** These subparagraphs say, rather obtusely with various cross references, exceptions, and special rules layered over the existing provisions, that if the beneficiary is a designated beneficiary (DB) (generally meaning that they are human beings), the plan assets must be distributed within 10 years of the participant's death unless the beneficiary is an "eligible designated beneficiary" (EDB). A modified life expectancy payout applies as long as the beneficiary is an EDB.
- (iii) – **Death of or Otherwise Ceases to be EDB.** If an EDB dies or otherwise ceases to be an EDB before the plan has been entirely distributed, the exception for EDBs will no longer apply, but the plan must be distributed within 10 years after such EDB's death or cessation as an EDB (even if the next successor beneficiary is an EDB at that time).
- (iv) and (v) – **Special Rules for Trusts for Disabled or Chronically Ill Beneficiaries.** Special rules apply to multi-beneficiary trusts if at least one of the beneficiaries is a disabled or chronically ill individual (these provisions are discussed below); and
- (vi) – **Applicable to Defined Contribution Plans, Not Defined Benefit Plans.** These rules apply to defined contribution plans (including IRAs and Roth IRAs), but not defined benefit plans, i.e., pension plans.

Section 401(a)(9)(E) is amended to describe five categories of EDBs.

Section 401(b) of the SECURE Act has effective date provisions. The provisions generally apply to plans and IRAs for which the participant dies after 2019, but some effects may result even when participants have died before 2020.

A summary of various retirement plan beneficiary designation planning considerations under the SECURE Act is in Item 3 of the Heckerling Musings 2020 and Estate Planning Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** It is a detailed summary of comments made by Natalie Choate at various sessions at the 2020 Heckerling Institute on Estate Planning.

This balance of the comments about this seminar will just include musings about several specific issues.

46. Eligible Designated Beneficiaries

The five categories of EDBs are described in new Code Section 401(a)(9)(E)(ii). They are (i) the surviving spouse, (ii) a participant's child who "has not reached majority," (iii) a disabled individual, (iv) a chronically ill individual, and (v) an individual not described above who is not more than 10 years younger than the participant. These beneficiaries qualify for a modified life expectancy payout.

Status as an EDB is determined at the participant's death. A DB who later satisfies one of the five categories of EDBs does not become an EDB for purposes of being able to use an adjusted lifetime payout rather than being subject to the 10-year rule. §401(a)(9)(E)(ii)(last sentence). (A special rule applies for minors – if the minor is disabled upon reaching majority, the minor exception "may" continue through the period of disability, as discussed in Item 47 immediately below.)

The separate categories of EDBs and the effects of ceasing to be an EDB are discussed in Items 47-51, beginning immediately below.

47. Minor Child of Participant as EDB; "Reaches Majority"

This exception applies for a minor child *of the participant*, not a grandchild or any other person's child (such as a niece or nephew). The exception applies until the child "reaches majority" within the meaning of a specified unrelated provision (an obscure ERISA rule), which has a regulatory provision treating the child as not having reached majority if the child has not "completed a specified course of education" and is under the age of 26. Reg. §1.401(a)(9)-6, A-15. The 10-year rule applies, beginning when the child "reaches majority." Therefore, this exception could possibly extend to age 36. The meaning of a "specified course of education" is unclear.

In addition, if a minor child becomes disabled before reaching majority, the minority status "may" continue as long as the child is disabled. Reg. §1.401(a)(9)-6, A-15.

This exception applies if the minor child is the outright beneficiary or is the beneficiary of a conduit trust (but not an accumulation trust).

In light of the uncertainties mentioned above, Natalie Choate recommends that the regulations take the position that "age of majority" means age 26, continuing for as long as the child is disabled. Otherwise plan administrators will have to wrestle with the uncertainties of what constitutes a "specified course of education" in a particular situation or, for example, what happens if the student takes only a few hours some semester or flunks in some semester.

If distributions to a minor qualify for this exception, observe that the withdrawal rate will be very slow using the minor's life expectancy. Under the new Single Life Table (effective beginning in 2021), for example, a 15-year old has a life expectancy of 69.9 years, so the initial withdrawals would be about only 1/70th of the account. The withdrawal would likely be much less than the interest and dividend produced by the account, and the account would likely continue to grow during the period the minor qualified for EDB treatment. After the minor "reaches majority," further withdrawals from the account could be halted for 10 years, at which time the entire account would be withdrawn. That could possibly last until the "minor" child is 36 years old before most of the account balance would have to be distributed from the account to the beneficiary (or if the account is payable to a conduit trust, to the trust and from the trust to the beneficiary).

48. Surviving Spouse; Outright Gives Best Deferral; Special Provisions Needed for QTIPs

To qualify for the spouse exception, the benefits must be payable "to" the surviving spouse, which likely requires that the beneficiary is the surviving spouse outright, or a conduit trust for the surviving spouse (because the conduit trust rules treat the conduit beneficiary as the owner of the trust and plan for purposes of the minimum distribution rules).

a. **Conduit Trust as Beneficiary.** If a conduit trust for the spouse is a beneficiary (or if the spouse is the outright beneficiary), the spouse could take advantage of special spousal rules delaying beginning distributions until the end of the year in which the deceased participant would have turned age 72 (§401(a)(9)(B)(iv)(I), as amended by the SECURE Act) and using the Single Life Table but recalculating the life expectancy annually, Reg. §1.401(a)(9)-5, A-5(c)(2) (first sentence, A-6). If the spouse dies before all benefits are paid, the required minimum distribution for the year of death must be paid based on the recalculated life expectancy by the end of the year (if it had not previously been distributed that year), and the balance must be paid within 10 years of the spouse's death. (Before the SECURE Act, the benefits could be paid over the spouse's remaining life expectancy, with no recalculation following his or her death.)

b. **Standard QTIP Trust (Accumulation Trust) as Beneficiary.** A standard QTIP trust, that does not require that all retirement plan distributions to the trust be distributed to the spouse, would **not** qualify for this spousal special treatment, even if it is a valid see-though trust, Reg. §1.408-8, A-5(a). Under the SECURE Act, a standard QTIP trust does not qualify as an EDB and the 10-year rule would apply after the participant's death. A QTIP trust that also requires such distributions to the spouse of all plan distributions would constitute a conduit trust that is an EDB and would qualify for the spousal special treatment.

Prior to the SECURE Act (i.e., for participants dying before 1/1/2020), benefits passing to an accumulation trust for the surviving spouse would qualify for payout over the spouse's life expectancy (or, if shorter, the life expectancy of remainder beneficiaries of the trust).

Planning Pointer: If a client (probably in a second marriage) wants the surviving spouse to have merely life use of the retirement benefits as needed, and not receive all retirement plan distributions, the client will likely need to use an accumulation trust and the plan benefits will have to be paid to the trust under the 10-year rule.

c. **Spouse as Outright Beneficiary.** If the spouse is the outright beneficiary, additional alternatives are available (in addition to the option described above if a conduit trust for the spouse is the beneficiary). The spouse can elect to treat the IRA as his or her own, or may roll over the plan benefits into the spouse's own rollover IRA. Advantages include a delayed starting date (until the surviving spouse reaches age 72) and a slower payout (using the Uniform Life Table). Under the SECURE Act the spouse would no longer have the ability to name a beneficiary who can receive the payout based on the beneficiary's life expectancy, but the remaining benefits would have to be paid by the end of the year in which the tenth anniversary of the spouse's death occurs. If a beneficiary is an EDB at the time of the surviving spouse's death, the EDB rules should apply for that beneficiary (because the spousal rollover IRA is treated as the spouse's IRA, §§408(d)(3)(A), 408 (d)(3)(C)(ii)(II)).

49. Disabled or Chronically Ill Individuals

a. **Outstanding Resource.** An outstanding resource regarding planning for the disabled and chronically ill EDB category (and in particular, planning for special needs trusts in light of the SECURE Act) is Nancy Welber, *Security for Disabled and Chronically Ill Beneficiaries*, TRUSTS & ESTATES 40 (April 2020) (hereinafter "Welber, Disabled and Chronically Ill Beneficiaries"). Some of the information in this section of the summary is derived from that excellent article.

b. **Definitions of Disabled and Chronically Ill.** The SECURE Act provides cross references to definitions of disabled or chronically ill individuals. For example, a person who qualifies for Social Security disability benefits generally qualifies for this exception. Section 401(a)(9)(E)Iii) references §72(m)(7) regarding disabled persons and §7702B(c)(2) regarding chronically ill individuals.

The definition of "disabled" in §72(m)(7) and Reg. §1.72-17A(f) is an individual who is "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." This is similar to the definition for Social Security Disability Income (SSDI) or Supplemental Security Income (SSI) except that an "indefinite" disability expected to last for life is required. Section 72(m)(7) requires proof of disability but the regulations do not address how disability is proven.

The chronically ill category is defined by reference to §7702B(c)(2)(A), which governs the treatment of long-term care contracts. The chronically ill individual must (i) be unable to perform (without substantial assistance from another individual) at least two activities of daily living listed in §7702B(c)(2)(B), (ii) have a disability similar to that level, OR (iii) require substantial supervision to protect the beneficiary from threats to health and safety due to severe cognitive impairment.

c. **Certification Requirement.** Section 72(m)(7) requires proof of disability and §7702B(c)(2) requires certification as chronically ill by a licensed health care practitioner. When such certification must be given is unclear. Rumors surfaced that the IRS might take the position that such certification must be in place at the time of the retirement plan participant's death. ACTEC filed comments with

representatives of the Treasury and IRS on March 31, 2020, recommending that no such certification should be required before a reasonable time has passed after the issuance of long-term guidance on the issue, and "that either interim or long-term guidance should provide that no certification will be required until a reasonable and specified amount of time has passed after the death of the employee who has designated the beneficiary, provided of course that the certification confirms that the beneficiary was in fact disabled or chronically ill as of the death of the employee."

One commentator suggests that such certifications should be required by October 31 of the year following the year of the participant's death, analogous to the time for providing other documentation under Reg. §1.401(a)(9)-4, A-6. Welber, Disabled and Chronically Ill Beneficiaries at 41.

d. **Very Important for Special Needs Trusts.** The disabled or chronically ill category of EDBs is particularly important in allowing the use of special needs trusts to receive retirement benefits over the lifetime of the disabled or chronically ill individual.

e. **Applicable Multi-Beneficiary Trust (AMBT) Provisions.** A special provision under §401(a)(9)(H)(v) for multi-beneficiary trusts for disabled and chronically ill beneficiaries gives these three categories of EDBs benefits not enjoyed by other EDBs.

- A mandated division at the participant's death is given effect, contrary to the result described for retirement plan distributions generally in Reg. §1.401(a)(9)-4, A-5(c), which generally prohibits benefits passing to a trust from being divided into separate accounts after the participant's death (for example if a portion of a single pot trust is divided into a separate trust for a disabled or chronically ill child, that separate trust would qualify for this exception and separate trust accounts for other DBs would be subject to the 10-year rule).
- A single trust with multiple disabled or chronically ill individuals as beneficiaries qualifies for the exception (although using a single trust is not recommended until we have further guidance because of various uncertainties).
- An **accumulation trust** for disabled or chronically ill beneficiaries qualifies for the exception (whose life expectancy is used in that case is not clear, and the conservative approach, until the IRS gives further guidance, is to have remainder beneficiaries who are no older than the disabled or chronically ill current beneficiary or beneficiaries).

Planning considerations in light of these special AMBT rules are summarized in the Welber article.

> In practical terms, the AMBT is a revocable trust [a footnote clarifies that a testamentary trust named in the beneficiary designation could also be used] that holds retirement benefits for multiple beneficiaries: (1) in an SNT for the special needs beneficiary's lifetime; and (2) in trust or, presumably, outright for the other individual trust beneficiaries. The trust structure is a departure from the current regulations and the separate account rule that doesn't apply to trusts.
>
> …
>
> [T]he AMBT provisions suggest that the revocable trust designated beneficiaries will use the 10-year rule to determine the applicable distribution period (payout period) for their outright or trust shares of the inherited IRA payable to the trust, and the SNT will use the life expectancy of the special needs beneficiary to determine the payout period for the SNT.
>
> If this interpretation is adopted in the SECURE Act regulations, it will be a welcome development. Will the AMBT be a panacea for families of special needs beneficiaries? I'm not sure. Absent more guidance, the AMBT seems perfect for a family with adult children, one of whom is a special needs beneficiary. The other beneficiaries will take their shares outright or in trust using the 10-year rule. If Treasury accepts the concept that the separate account rule applies to the AMBT structure, then this will add much flexibility to planning for families. The account owner can designate her revocable trust as the beneficiary of her retirement accounts. The trustee, given the power to select which assets should fund the various trust shares (a pick-and-choose power) may allocate more of the retirement benefits to the SNT, which is a more valuable asset for the SNT than for the other beneficiaries or trusts. Welber, Disabled and Chronically Ill Beneficiaries at 42.

f. **Special Needs Trusts Drafting.** Being able to use accumulation trusts is particularly helpful for special needs trust planning. Further IRS guidance is needed with respect to various issues for special needs trusts, including the certification requirements discussed above. As examples of the need for further guidance, many special needs trusts include a "backstop provision" allowing distributions to other beneficiaries of amounts that would cause the disabled beneficiary not to qualify for government assistance programs or include a provision allowing distributions to other beneficiaries for tax planning in light of the high rates applied to undistributed trust income. That type of provision (and other provisions commonly included in special needs trusts) should be excluded from special needs trusts designed to receive retirement benefits.

The Nancy Welber article has an excellent summary of changed drafting considerations for special needs trusts (referred to in that article as SNTs) in light of the SECURE Act.

> What should estate planners do before we have guidance from Treasury? The safe course is to assume that the current regulations will apply unchanged. Therefore, draft defensively. The SNT must include only special needs beneficiaries. Don't allow the SNT to terminate during the special needs beneficiary's lifetime if the trust no longer qualifies for public benefits, a "poison pill" that's common in special needs planning in some states. Don't allow the trustee to distribute excess income from a trust that has an inherited IRA payable to it to a beneficiary who isn't special needs. Don't allow payments to a companion for travel with the beneficiary. If any of these strategies are desirable, create a separate SNT for the non-retirement trust assets.
>
> Include a statement of intent in the AMBT that makes clear that the settlor intends that the trust qualify as an AMBT. Consider allowing the trustee to reform the trust, or allow a trust protector to amend the trust, so that the trust can comply with any Treasury regulations or other guidance that you may not anticipate at this time. The trustee or trust protector should be directed to make any changes by Sept. 30 of the year following the year of the account owner's death, which is the date by which the trust beneficiaries must be identified, and the trust must be a see-through trust. Given that we don't know whether the life expectancy of the oldest of multiple special needs beneficiaries of an SNT will be used to determine the payout period of the RMDs, and what happens to the payout period after the death of one of the special needs beneficiaries, it's safer to avoid an SNT with multiple special needs beneficiaries until we have guidance from Treasury. As for the remainder beneficiaries of the SNT, while it appears that if they're all individuals, their life expectancies should be irrelevant, be cautious and err on the side of naming outright beneficiaries who are younger than the special needs beneficiary, or close in age, like siblings or first cousins, so that the special needs beneficiary's life expectancy is more likely to be used. Welber, Disabled and Chronically Ill Beneficiaries at 43-44.

50. Less-Than-10-Years Younger Beneficiary

A classic example for this exception would be siblings of the participant who are older than the participant or not more than 10 years younger than the participant. Distributions made outright or to a conduit trust for such a beneficiary will qualify for this exception.

Different siblings may be treated quite differently. Distributions to a sibling who is 9 years and 364 days younger than the owner would qualify for the lifetime payout but distributions to a sibling who is 10 years and 1 day younger would have to be paid within 10 years.

51. Death of EDB or Beneficiary Otherwise Ceases to Be an EDB

At the death of a DB who is not an EDB (someone Natalie Choate refers to as a PODB, or "plain ol' designated beneficiary"), the benefits must still be paid out within the **ORIGINAL** 10-year period (actually by December 31 of the 10th year) after the participant's death.

When an EDB ceases to be an EDB, the benefits must be paid within 10 years of **THAT** time and not over the EDB's remaining life expectancy (for example, 10 years following the death of a surviving spouse or beneficiary not more than 10 years younger than the participant). §401(a)(9)(E)(iii).

When the EDB ceases to qualify as an EDB (due to death or any other reason), whether the successor beneficiary would qualify as an EDB at that time does not matter—the 10-year rule applies when the original EDB is no longer an EDB.

52. Conduit Trusts

a. **General Description.** A conduit trust is the nickname (not formally called that in the regulations) of a trust that has one individual beneficiary, and the governing instrument requires that all plan or IRA distributions to the trust must be distributed from the trust to the individual beneficiary. The distributions are deemed paid "to" the individual beneficiary, and the beneficiary is considered the sole beneficiary of the trust and the plan or IRA for minimum distribution purposes, regardless who receives any benefits if the beneficiary should die before all plan assets have been distributed to the trust (and to the beneficiary). A conduit trust is a see-through trust that qualifies as a designated beneficiary. Conduit trusts are straightforward to draft; they just require that plan distributions to the trust are distributed forthwith to the single beneficiary.

b. **EMERGENCY IMPACT – Danger of Conduit Trusts Under SECURE Act.** Conduit trusts were much simpler than accumulation trusts in the past because subsequent beneficiaries and permissible appointees are not relevant for purposes of determining the relevant life expectancy payout period. Conduit trusts have often been used in the past because of their relative simplicity. They worked fine because, even though benefits received by the trust had to be immediately distributed, the benefits were received by the trust very slowly over the beneficiary's lifetime. However, under the SECURE Act, the benefits will have to be paid out within 10 years (unless the beneficiary is an EDB). As a result, other than situations in which conduit trusts are used for EDBs, Natalie Choate concludes that "almost invariably, conduit trusts will not work the way the client anticipated or wants."

   If a trust is needed for an EDB, the planner will typically use a conduit trust for the various EDB categories other than the disabled or chronically ill exception (because §401(a)(9)(H)(v)(III) explicitly allows accumulation trusts to qualify for that exception).

53. Accumulation Trusts

An accumulation trust is a trust that is not required to distribute all plan benefits as received, but permits the accumulation of distributions within the trust. All beneficiaries (except "mere potential successor beneficiaries") who might ultimately receive such accumulations are considered for purposes of the minimum distribution rules (and the oldest such beneficiary's life expectancy is used as the relevant payout period). These restrictions have led to considerable complexity in drafting accumulation trusts to assure that some older beneficiary or entity might not be a trust recipient, including under the possible exercise of a power of appointment.

Going forward, accumulation trusts subject to the 10-year rule perhaps can be simpler – merely excluding any non-humans as potential beneficiaries (other than as "mere potential successor beneficiaries") or as possible appointees under a power of appointment. However, planners may want to hold off on simplifying provisions in accumulation trusts designed to limit who might be the oldest potential beneficiaries until we get further guidance from the IRS. *See* Natalie Choate, *Drafting See-Through Trusts After the SECURE Act*, TRUSTS & ESTATES 36, 38 (April 2020) ("It must be possible to identify the oldest trust beneficiary. This rule isn't really needed anymore, because (with the 10-year rule) we don't need to find the life expectancy of the oldest trust beneficiary. Perhaps the Treasury will remove this rule when it issues its post-SECURE Act regulations. However, this hasn't happened yet and may never happen, so the only safe route now still is to make sure you can identify the oldest potential countable beneficiary.")

54. Power of Attorney Drafting Changes

In light of the uncertainty about what future SECURE Act guidance will provide, some planners suggest that powers of attorney be drafted more broadly, to "include provisions that allow the agent to update beneficiary designations so that shares of an IRA can change as needs of the family changes." Welber, Disabled and Chronically Ill Beneficiaries at 44. Of course, this gives a very broad power to shift what may be a substantial portion of the participant's estate, so the client must be very comfortable with the agent having this power.

55. Income Tax Planning to Avoid Bunching

Unless beneficiaries are EDBs qualifying for a lifetime payout, income tax planning will become more important under the SECURE Act. Distributions do not have to be made proportionately over the 10-year term; they could be made all in a lump sum at the very end of the term (which would have the effect of deferring recognition of the income, but would also result in "bunching" the income, possibly into a high income tax bracket).

Planners will need to analyze optimal withdrawal amounts, in part considering what withdrawal rate would permit the beneficiary to receive the distributions in lower income tax brackets.

For Roth IRAs, deferral until year 10 would likely be the most effective strategy.

56. Roth IRAs

The SECURE Act retroactively removed a major advantage of Roth IRAs, and they are not as advantageous as in the past. Accumulations in Roth IRAs will never be subject to income tax when they are distributed to beneficiaries, so being able to defer distributions as long as possible is extremely advantageous. The advantage of not having to take required minimum distributions during the owner's life remains, but following the owner's death, the amounts in the Roth IRA must be distributed within 10 years (unless one of the EDB exceptions applies). But the creation of new Roth IRAs (with after-tax income or by converting traditional IRAs and paying income tax on the full current amount in those IRAs) may continue to make sense for some clients.

57. Other SECURE Act Changes – Required Beginning Date, Age Limit on IRA Contributions, Qualified Charitable Distributions from IRAs

a. **Required Beginning Date.** The SECURE Act changes the age that determines the required beginning date (RBD) for minimum distributions (April 1 of the following calendar year) from 70½ to 72, effective for individuals who reach age 70½ after December 31, 2019. The effect was that under the SECURE Act no one would have an RBD in 2021 (but §409(a)(9)(I), added by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), provides that RMDs are not required in 2020, which effectively could postpone a 2020 RBD to 2021 for anyone who had not already taken a distribution).

b. **Age Limit on IRA Contributions.** The SECURE Act also eliminates the prohibition on contributions to an IRA after age 70½ (but the $100,000 limit on qualified charitable distributions from an IRA would be correspondingly reduced).

c. **Qualified Charitable Distributions from IRAs.** Changing the age for required minimum distributions from 70½ to 72 under the SECURE Act does not change the age at which qualified charitable distributions from IRAs will be permitted.

   Particularly for nonitemizers, donors over age 70½ should consider making their charitable donations with IRA charitable rollovers at least up to the amount of the minimum required distribution and up to a maximum of $100,000 per year. Even though the nonitemizer donor does not get an income tax deduction, the donor will avoid recognizing income on the distributions. Especially if the donor has reached the RBD (April 1 of the year after reaching age 72 if the person had not reached age 70½ in 2019), the donor will avoid recognizing income on the required distributions from the IRA.

Items 58-66 are observations from a seminar by Professor Gerry W. Beyer, Michael Gordon, and Sally H. Mulhern, Just Because You Are Still Alive Doesn't Mean You Cannot Probate Your Will: Ante-Mortem Probate as the Ultimate Will Contest Prevention Technique.

58. Anticipated Contest Situations

Situations in which a contest might be suspected include the following:

- Descendants or other "natural objects of the bounty" are excluded as beneficiaries
- Unequal treatment of children (different amounts or some in trust and others not in trust)

- Sudden change of the dispositive plan
- Excessive restrictions on beneficiaries who are also heirs and could receive assets outright if the will is not valid
- Blended marriages
- Beneficiary who was promised a bequest and will not be receiving it
- Unusual beneficiaries (e.g. a caretaker of the beneficiary)
- Litigious family members (someone might contest just to force a settlement even though no valid grounds for a contest exist)
- Older or disabled testator
- Eccentric testator

59. Steps to Avoid Will Contest

The following are some of the steps that might be taken to minimize the risk of a potential will contest:

- No contest clause
- Videotape the execution of the will
- Visit the testator's physician around the time the will is executed
- Execute multiple wills so the contestant would have to successfully contest all of them before receiving assets as an heir
- Buy off the potential contestant in a contract
- Make a gift to the person who might contest the will on the day the will is executed (if the gift is accepted, the donee arguably must have thought the donor was competent on that day)
- Take special steps in the execution process
- Other techniques are possible as well, this is not an exhaustive list

None of these is foolproof; there is no 100% guaranty with any of these techniques. The ante-mortem probate procedure, if available, offers a 100% guarantee that the will cannot be contested. Once the appeal period has run following the ante-probate proceeding judgment, the will cannot be contested.

60. Ante-Mortem Probate—Basic Description

An ante-mortem probate process is allowed, in various forms, in nine states. It offers a procedure by which a declaratory judgment (or other court order) is obtained while the testator is still alive that the will is valid, and cannot be contested after the testator dies. After appeal periods have run, the will cannot be contested. In some states (such as Delaware), an order is not obtained declaring that the will is valid, but after notice is delivered, if a contest is not filed within a specified time period, the will is determined to be valid and cannot be contested.

The three methods of attacking the validity of a will are (1) invalid execution, (2) lack of testamentary capacity, and (3) undue influence. If execution requirements are not satisfied, the will can be re-executed and the technical errors eliminated. The testator is available to testify regarding his or her capacity (including the knowledge of his or her assets and the effects of the will) and that the will is not the result of undue influence. Spurious will challenges will be reduced because many possible contestants would not be willing to face the testator with a spurious claim to try to force a settlement.

61. Historical Development

Old English law and old European civil law have references to pre-mortem probate. In the United States, Michigan was the first state with a pre-mortem probate statute in 1883, but it was declared unconstitutional within two years. Texas in 1943 authorized declaratory judgments for the validity of a will when the testator was alive, but a court held that it had no jurisdiction to determine the validity of a will while the testator was alive.

The National Conference of Commissioners on Uniform State Laws in the 1930s developed a proposed statute but decided that it went beyond merely reforming or updating current legislation. A 1967 draft of the Model Probate Code had a pre-mortem probate procedure, but it was not included in the Model Act. The Uniform Probate Code would have included a Uniform Ante-Probate of Wills Act, but agreement could not be reached on which approach to use (the Joint Editorial Board was exactly evenly divided), and the project was cancelled.

Three states in the late 1970s adopted pre-mortem probate procedures, North Dakota (1977), Ohio (1978), and Arkansas (1979). Beginning 31 years later, other states began adopting pre-mortem probate statutes, Alaska (2010), New Hampshire (2014), Delaware (2015), and North Carolina (2015). Two other states (Nevada and South Dakota) have very simple provisions in their declaratory judgment statutes authorizing a declaratory judgement as to the validity of a will or trust, but without any detailed procedures.

Thus, the nine states recognizing some form of pre-mortem probate procedures are North Dakota, Ohio, Arkansas, Alaska, New Hampshire, Delaware, North Carolina, Nevada, and South Dakota.

In subsequent years, some of those states have expanded their procedures to cover the validity of inter vivos trusts (Alaska, Delaware, Nevada, New Hampshire, Ohio, and South Dakota) and the exercise of powers of appointments (Delaware and Nevada).

62. Key Differences in Statutes

a. **Format of Process.** Most of the states with these statutes provide for obtaining an order that a will is valid. Some other states (such as Delaware) provide notice to beneficiaries, persons who would be heirs, or anyone else to be bound by validity of the will, and if such persons do not file a contest within a specified period of time (120 days in Delaware), the will cannot be contested. (Delaware also has a similar procedure for the validity of trusts, which is important particularly for estate plans with a revocable trust and pourover will, and for exercises of powers of appointments.) In Delaware, the process is also binding on persons whom the individual that receives notice can represent under the virtual representation statute.

b. **Standing.** Some states just allow a testator to bring the proceeding. Alaska also allows certain others to bring the proceeding – a person named as executor or any interested persons (i.e., a beneficiary) that have the consent of the testator to bring the action.

c. **Connection with State.** Most states require that the testator (or settlor or the trustee for trusts) have some connection with the state – as a domiciliary, resident or someone who owns real estate in the state. However, Alaska does not require any nexus with Alaska, so a resident of any state can obtain an order from an Alaska court that the will is valid. If the testator's home state provides (as most states do) that if a will is valid in the state where it is executed, it will be valid in the other state also. In this manner, residents of most states could take advantage of an ante-mortem probate process by using the Alaska procedure.

d. **Revocation.** Most states allow the testator to amend or revoke the will without a further ante-mortem probate procedure, but the testator will have lost the protection of the order that validated the prior will. North Dakota requires a court action to change the will, and North Carolina gives the court discretion to declare that a new procedure is necessary.

e. **Effect After Death.** In most states, the will is incontestable after death. North Carolina allows a contest if clear and convincing evidence establishes that the testator was subject to financial or physical duress or coercion during the ante-mortem proceeding.

f. **Effect of Non-Use.** Most states expressly state that non-use of the procedure cannot be used as evidence that the will could be invalid. Some states also provide that failure to use the ante-mortem probate procedure can be the basis of a malpractice action by the beneficiaries against the attorney.

63. Key Advantages of Ante-Mortem Probate Procedure

a. **Testator Available.** The testator is available for observation and to testify as to capacity and the lack of undue influence.

b. **Reduces Will Contests.** After the appeals period has run regarding the order that the will is valid, it cannot be contested.

c. **Carries Out Intent.** The process facilitates carrying out the testator's/settlor's intent.

d. **Anticipate Children Will Not Object.** Some clients will be willing to go through the process, in circumstances in which a contest may be more likely than the typical situation, if the client anticipates that the children will not come forward when the client is alive to challenge the documents.

e. **Even If Anticipate Children Will Object.** Even if the client anticipates that children will object, the client may want to proceed to face the children directly and to have the ability to convince a court that the client has capacity and is not being unduly influenced.

64. Key Concerns

a. **Family Disruption.** The proceeding may be disruptive to the family.

b. **Contents of Will Revealed.** In most states, the process will result in revealing the contents of the will.

c. **Embarrassment Potential.** The client will be embarrassed if not successful (for example, if the court finds that the testator does not have capacity).

d. **Cost.** The proceeding has an associated cost (but much lower cost than a post-death contest proceeding).

e. **Disrupts Future Reconciliation.** If the will excludes the daughter as a beneficiary, she may not come to Thanksgiving dinners again. A response to that concern is that in dysfunctional family situations, employ counseling, etc. prior to bringing the action.

f. **Chilling Effect on Future Changes.** Once the validity order is obtained, the client may be reluctant to make future changes to the will so that the protection of the validity order will not be lost.

65. Practice Tips

a. **Willingness to Alienate Family Members During Life.** The client may be unwilling to confront and alienate a family member during life, knowing that doing so will mean the client may never again see that family member or (maybe more importantly) his or her children (who may be the client's grandchildren).

b. **Effective Witness?** Will the client be an effective witness to establish his or her capacity or the lack of undue influence?

c. **Be Proactive.** Be proactive in anticipation of the client's testimony. For example, have the client draw a family tree and provide financial information, have numerous meetings with the client in preparation of the hearing, go through the will with the client paragraph by paragraph and give the client the opportunity to make changes, and select document witnesses and the notary based on experience and the ability to testify credibly at the hearing.

d. **Separate Counsel.** The attorney that drafted the estate plan will be a witness in the ante-mortem probate proceeding, so separate counsel should bring that action.

e. **Drafting Attorney May Draft Petition.** The estate planning attorney may draft the petition, because he or she is most familiar with the situation, and then provide the draft to the attorney who will handle the probate proceeding.

f. **Make Process Easy for Court.** Make the process as easy as possible for the court, providing a family tree, summary of assets, summary of the estate plan, and a proposed order.

g. **Notice.** Give notice to everyone. Some states require notice to all possible interested parties; in any event, only parties who receive notice will likely be bound by the proceeding. Use virtual representation if available under state law.

h. **Difficult to Locate Parties.** Some necessary parties may be difficult to locate. Additional time and investigation may be required.

i. **Illegitimates.** Disinheriting an illegitimate child can be tricky.

j. **No Contest Clause.** Some states specifically allow a no contest clause to be used in connection with the ante-mortem probate proceeding.

k. **Quiet Trusts.** If a proceeding is instituted to validate a trust that has quiet trust provisions (for example, a designated representative receives notice for the settlor's life), will the represented beneficiaries be bound by the designated representative's failure to object in the validity proceeding?

66. Delaware *Ravet* Case Upholding Validity of Trust

The Delaware Supreme Court upheld the validity of a trust under the Delaware validation statute. Notice was delivered to trust beneficiaries, giving them 120 days to file a challenge to the validity of the trust. One son filed an action with the court well after the 120 day period, but did not serve the petition on the trustees until after the settlor died. The son then proceeded with the contest, but the court upheld the motion to dismiss the case because the petition was time-barred under the ante-mortem validation statute. *Ravet v. Northern Trust Co. of Delaware*, 2015 WL 631588 (Del. 2014).

Items 67-74 are observations from a seminar by Reynolds T. Cafferata, Erik Dryburgh, and Professor Susan N. Gary, Uniform Prudent Management of Institutional Funds Act (UPMIFA) Conundrums: Issues in Making and Managing Charitable Gifts.

67. Overview of UPMIFA

The Uniform Prudent Management of Institutional Funds Act (UPMIFA, and sometimes referred to in the summary of this seminar as the "Act") among other things:

(i) Modernizes the rules governing expenditures from endowment funds, both to provide stricter guidelines on spending from endowments, giving institutions the ability to cope more easily with fluctuations in the value of an endowment, and increasing flexibility while providing better guidance with the goal of protecting donors' intent;

(ii) Spells out factors a charity should consider in making investment decisions, imposing a modern, well accepted, prudence standard based on the Uniform Prudent Investor Act; and

(iii) Updates provisions governing the release and modification of restrictions on charitable funds (including modifications with the consent of the donor).

Some version of the Act has been adopted in all states other than Pennsylvania (which has its own version of legislation addressing these issues).

68. Coverage of (and Some Important Definitions in) UPMIFA

UPMIFA applies to "**institutional funds**," which are certain funds held by "**institutions**," defined as a person (other than an individual) organized and operated for charitable purposes, a governmental entity to the extent it holds fund exclusively for charitable purposes, and a trust after all noncharitable interests have terminated. UPMIFA §2(4) (references to a § in the summary of observations about this seminar

generally refer to sections of UPMIFA). Institutional funds are funds held by an "institution" exclusively for charitable purposes, but not including program-related assets, and not including a fund held by a trust having a trustee other than the institution. §2(5). Thus, charitable trusts with an individual or corporate trustee are not subject to UPMIFA.

The portion of the Act dealing with spending limits applies to "**endowment funds**," which are institutional funds that, under the terms of a "gift instrument," are not wholly expendable on a current basis. They can have a permanent duration or a duration for some fixed term but cannot be wholly spent currently.

A "**gift instrument**" is defined very broadly to include records, including a solicitation, under which property is held as an institutional fund. It can be a formal gift agreement, an informal letter from a donor outlining the donor's intentions about a charitable gift, or solicitation materials. (Solicitation materials may create restrictions on gifts contributed in response to the solicitation.)

69. Spending Guidance and Limitations

a. **Background – Change From Approach Under UMIFA.** The prior Uniform Management of Institutional Funds Act (UMIFA) provided that a gift for endowment or subject to distribution of just income meant that the donor intended to permit the charity to spend a prudent amount of appreciation. UMIFA allowed charities to spend appreciation as long as the fund was above its "historic dollar value" (i.e., the amount of contributions to the fund). If the fund was below the historic dollar value, it could continue to spend interest, dividends, rents, and royalties. This approach did not preserve the purchasing power of the fund on a long-term basis.

b. **General Spending Guidance in UPMIFA.** For endowment funds, the spending guidance in §4(a) of the Act gives funds a significant degree of flexibility. Subject to donor intent otherwise expressed in the gift instrument, the fund "may" spend or accumulate so much as the institution determines is prudent for the purposes and duration for which the fund is established. In making spending decisions, the institution "shall" act in good faith, with the care of an ordinarily prudent person, and "shall" consider, if relevant, the following factors: "(1) the duration and preservation of the endowment fund; (2) the purposes of the institution and the endowment fund; (3) general economic conditions; (4) the possible effect of inflation or deflation; (5) the expected total return from income and the appreciation of investments; (6) other resources of the institution; and (7) the investment policy of the institution." Any limitation on this general authority to spend or accumulate must be specifically stated in the gift instrument. §4(b).

   These provisions seem to indicate that some minimal level of spending is required, and the fund cannot simply warehouse funds indefinitely. The fund "shall" act in good faith in considering various factors including the charitable purposes of the fund.

c. **Rebuttable Presumption of Imprudence.** About half of the states have adopted an optional §4(d) of the Uniform Act, which provides that spending in any year that exceeds 7% of the fair market value of the endowment fund, determined at least as often as quarterly over a three-year period preceding the year in which the spending occurs, "creates a rebuttable presumption of imprudence." Distributions permitted under other laws or the gift instrument are not subject to the presumption. §4(d)(1).

   On the other hand, distributions of 7% or less are not presumptively prudent. Thus, the 7% guidepost is not a safe harbor for a charity's spending, but spending exceeding 7% is presumptively imprudent, which would then require the charity, if questioned, to justify its actions. The Comments to the Act clarify that if the facts "raise the presumption of imprudence, then the institution will have to carry the burden of production (i.e., the burden of going forward with) other evidence that would tend to demonstrate that its decision was prudent. The existence of the presumption does not shift the burden of persuasion to the charity."

   An overall goal of UPMIFA, as compared to UMIFA, is to place some caps on spending to preserve the purchasing power of endowment funds over the expected life of the fund.

d. **Donor Overriding UPMIFA's Spending Rules.** The spending rule in UPMIFA is a rule of construction as to what a donor intended by using terms such as "endowment" or "pay only the income." Section 4(a) begins by saying that the spending guidance in §4 is "subject to the intent of a donor expressed in the gift instrument." How would a donor overcome the spending rules? The Comment to §4 provides that an instruction to "pay only the income" will not be specific enough, but an instruction to "pay only interest and dividend income" earned by the fund would be. If a donor does not want the spending rule in UPMIFA to apply, the donor should be as specific as possible.

e. **Fund Overcoming Rebuttable Presumption of Imprudence.** If a fund has distributions below 7% for a few years and then exceeds 7%, but does not bring the average over 7% for the four-year period, the presumption does not apply. The Comments to §4(d) discuss situations that might overcome the presumption. For example, limiting distributions for an extended period of time to save for a capital project and then taking a distribution that exceeds 7% of the four-year lookback may be prudent. "For some endowment funds fluctuating spending rates may be appropriate." Examples in the Comments address capital projects, but the rationale should extend to other activities that require an unequal large distribution in one year preceded or followed by years of minimal distributions. Comments suggest that the big distribution could come at the beginning or the end of the period of reduced spending.

   Other situations, beyond those mentioned in the Comments, might include having consistent higher returns to support distributions above 7%, or one-time exigent circumstances where the fund can demonstrate that the permanence of the fund will not be jeopardized.

f. **Are Private Foundations Subject to the Spending Rules of UPMIFA?** As a practical matter, most private foundations will not be affected by UPMIFA's spending rules. A gift with no donor restrictions or in response to solicitation materials that have no special purposes expressed does not create an endowment fund subject to the spending rules. The governing documents of corporate foundations typically do not have restrictions, and if they do, the governing documents can be amended to remove the restrictions. For that reason, if a donor who is creating a foundation wants to create restrictions, a trust format is typically used. Keep in mind, though, that UPMIFA does not apply to trusts unless the institution is also serving as the trustee.

   Observe that the 5% distribution requirement for private foundations in §4942 of the Internal Revenue Code is to assure that foundations spend enough, but UPMIFA is designed to assure that an endowment fund does not spend too much. The purposes of the two separate provisions are in tension with each other.

70. Investment Standards

a. **Overview.** Investment standards for public charities are governed by state law – (i) UPMIFA for charities organized as nonprofit corporations (and trusts for which the charity is serving as trustee), and (ii) the Uniform Prudent Investor Act (UPIA) for charitable trusts (for which the charity is not the trustee). The investment standards in UPMIFA are based on the standards in UPIA, so the same standards generally apply to all charities.

b. **Investment Standards in UPMIFA.** UPMIFA articulates prudence standards for the management of charitable funds by charities. While §3 of UPMIFA is based on the Uniform Prudent Investor Act, the rules are not identical. The rules in §3 are merely default rules that can be modified; however, the duty of care, the duty to minimize costs, and the duty to investigate are mandatory. A gift instrument or the governing instruments of a charitable organization can modify non-mandatory duties, subject to the charitable purpose doctrine. Therefore, responsible investment goals of an institution and its donors may be documented. As with the balance of UPMIFA, the investment standards provision does not apply to trusts managed by non-charitable corporate or other fiduciaries, even if they include charitable interests.

The investment standards in §3, "Standard of Conduct in Managing and Investing Institutional Fund," are summarized in the following discussion from the written materials for the seminar:

> UPMIFA articulates a standard of care for both managing and investing an endowment. It requires the charity to consider the charitable purposes of the charity and the purposes of the endowment fund. [§3(a)] It requires the Board (and others responsible for managing and investing) to act in good faith and with the care of an ordinary prudent person [§3(b)], and notes that the charity may incur only appropriate and reasonable costs [§3(c)(1)]. Except as otherwise provided in the gift instrument:
>
> - When investing, the charity must consider the following [§3(e)(1)]:
>   - general economic conditions,
>   - effects of inflation and deflation,
>   - tax consequences,
>   - the role of each investment in the overall portfolio,
>   - expected total return from income and appreciation,
>   - the charity's other resources, and
>   - the needs of the charity and the fund to make distributions and preserve capital.
> - Individual investments must be analyzed in the context of the total portfolio and the overall risk-reward objectives [§3(e)(2), and an institution may pool funds, §3(d)].
> - A charity can invest in any kind of property that is not inconsistent with the standard of care [§3(e)(3)].
> - The charity shall diversify the investments unless, because of special circumstance, the purposes of the fund are better served without diversification [§3(e)(4)].

c. **Multiple vs. Individual Funds.** Multiple funds may be commingled for investment purposes and considered as a single portfolio for appropriate risk sharing and diversification considerations. However, if a particular fund is restricted to being invested in a certain way, that fund cannot be commingled with others, and the prudent investment rule applies separately to that fund.

d. **Loans and Pledges.** While not directly addressed by UPMIFA, it is likely that an institution cannot borrow from an endowment fund for that institution. A loan is a contract, requiring two parties, and there would only be one party (the charity). Practically, who would sign as borrower and as lender? If the charity defaults on the loan, which directors will be the plaintiffs and which directors will be the defendants in the lawsuit to enforce the loan documents? The borrowing would likely be treated as an expenditure by the endowment fund beyond the allowed spending limits.

If a direct loan from an endowment fund is not allowed, can the charity borrow from a bank and pledge the assets of the endowment fund as collateral for the loan? Although the Comments to the Act suggests that pledging endowment funds as security loans is permitted under §3(e)(3), subject to §3(e)(1), panelists believe that pledges by endowment funds have similar concerns as loans from the funds. If the lender enforces the pledge, the appearance is that the assets in the endowment fund have been used for charitable purposes beyond the restrictions in the endowment fund, and a state attorney general would likely collapse the two transactions.

Banks have figured that out and few are willing to accept endowment funds as collateral for loans to charities. The California Attorney General has been successful in some cases in saying that endowment fund assets are not available to creditors. At the least, the bank would want a legal opinion that the endowment funds are valid collateral (and at least some of the panelists would be unwilling to give that legal opinion).

e. **Donor Overriding Prudent Investment Standard.** Some overall limits exist on the ability of a donor to override investment standards. The Comment to UPMIFA §3(b), §3(c)(1), and §3(c)(2) states that the duty of care, duty to minimize costs, and duty to investigate are mandatory, but other provisions of §3 are default rules and can be modified by the gift instrument. For example, the duty to diversify appropriately is in subparagraph (4) of §3(e), and §3(e) begins "Except as otherwise provided by a gift instrument." However, the donor cannot control the management of the charity.

The situation that most often raises this issue is when a donor wants the charity to retain a certain asset indefinitely or for a certain specified period of time. That may be sufficient to override a duty of diversification as to that asset, but such a restriction may reduce the amount of federal income tax charitable deduction that may be allowed for the charitable donation. *See* Rev. Rul. 2003-28. An alternative is for the gift instrument to recommend and authorize, but not require, the charity to retain such assets. For example, "I authorize the charity to retain the donated assets. This is intended to override the UPMIFA general investment standards and particularly the duty to diversify." The Comment to §3(e)(4) indicates that "[a] decision not to diversify must be based on the needs of the charity and not solely for the benefit of a donor. A decision to retain property in the hope of obtaining additional contributions from the same donor may be considered made for the benefit of the charity, but the appropriateness of that decision will depend on the circumstances."

f. **Program-Related and Mission-Related Assets.** The Comment to §3(e)(1) of the Act states that "[a]ssets held primarily for program-related purposes are not subject to UPMIFA." For assets that are not held primarily for program-related purposes but have both investment and program-related purposes, the charity can consider the relationship between an investment and the purposes of the institution in making an investment that may have a program-related purpose.

The Act does not address mission-related assets (that are not used directly in the programs of the charity but have a relationship to the charitable purposes of the institution). Section 3(a) of the Act states at the beginning of the standard of conduct that an institution "shall consider the charitable purposes of the institution and the purposes of the institutional fund" in making investment decisions, and §3(e)(1)(H) says that the charity "must" consider "an asset's special relationship or special value, if any, to the charitable purposes of the institution." Treasury Notice 2015-62 (addressing private foundation restrictions on jeopardizing investments) observes that under state law (UPMIFA or UPIA), a charity can consider its mission in making investment decisions.

71. Release or Modification of Restrictions

a. **Brief Summary of UPMIFA Provisions.** The restriction modification provisions of UPMIFA are summarized in the written materials as follows.

> UPMIFA allows a charity to release or modify a restriction as follows.
>
> (1) The charity may release or modify a restriction regarding the *management, investment, or purpose* of a fund if the donor consents in writing. [§4(a)]
>
> (2) If a *purpose or use* restriction becomes unlawful, impracticable, impossible to achieve, or wasteful, the court may modify the restriction in a manner consistent with the donor's intent. The Attorney General must be notified. This is similar to the cy pres doctrine. [§4(c)]
>
> (3) The court can modify a *management or investment* restriction if it has become impracticable or wasteful, impairs the management or investment of the fund, or (if due to unforeseen circumstances) the release would further the purposes of the fund. The Attorney General must be notified. This is similar to the deviation doctrine. [§4(b)]
>
> (4) If a fund is less than $[25,000] in value and over [20] years old, and the charity determines that a restriction on the *management, investment, or use* of the fund is unlawful, impracticable, impossible to achieve, or wasteful, the charity can (after notice to the Attorney General) release or modify the restriction. It must thereafter use the funds in a manner consistent with the donor's charitable purposes. [§4(d); some enacting states have increased the amount considered small]
>
> …
>
> None of the methods in #1, #2 and #4 directly address "spending." Does spending fall within purpose and/or use?

b. **Multiple Donors.** If multiple donors contribute to a fund, the consent of all of the donors will generally be required to release or modify restrictions. For example, if spouses contribute to a fund, after the death of one of the spouses, the surviving spouse could consent to release or modify a restriction as to the half contributed by him or her. State property rights giving spouses management authority as to marital or community property might be a basis for a surviving spouse to consent to a release or modification as to the entire donation.

72. Administrative and Fundraising (Development) Fees

Can administrative overhead or fundraising costs be charged to a fund that is restricted to a particular purpose?

Charities often charge funds held for a particular purpose for general administrative overhead costs. Donors typically understand that and accept the concept if the charge is reasonable.

Clients are less willing to agree that fundraising (development) costs should be charged against the restricted fund. A charity may adopt a gift acceptance policy given to the donor indicating that developments costs may be charged as part of the general overhead charges, but whether a donor's affirmative consent to such charges will be necessary is unclear.

73. Donor Standing to Enforce Restrictions

UPMIFA does not address donor standing to enforce restrictions. Its silence regarding donor standing was not intended as a statement against donor standing. The Uniform Trust Code includes donor standing for donors to charitable trusts.

74. Grants From One Private Foundation to Another Private Foundation

If a private foundation makes a distribution to another private foundation, the donating foundation will have to exercise expenditure responsibility "forever" until the funds have been spent unless it is an "endowment grant." Does that make the grant subject to UPMIFA when the funds were not originally an endowment fund subject to the UPMIFA spending rules? One panelist's approach is to provide that the grant from the donating foundation is an endowment grant for purposes of §4942 of the Code, but is not an endowment grant under UPMIFA. (Whether that works is untested.)

Items 75-81 are observations of a seminar by Jocelyn Margolin Borowsky, Barry A. Nelson, and Gideon Rothschild, Having Your Cake and Eating it, Too – Transfer Planning for the Moderate ($11 Million+) Estate

75. Impact of Possible Future Legislation

The $10 million indexed gift and estate exclusion amount is scheduled to revert to $5 million indexed in 2026, but future legislation could accelerate that sunset date. One panelist indicated that his firm has a policy against any of the estate planning section personnel from scheduling vacations after the election this November in case we find that a change of administration will occur. If so, the panelist is concerned that the high exclusion may be rolled back sometime in 2021, and that it might even be retroactive to January 1, 2021.

In any event, clients should be aware of the window of opportunity for taking advantage of the large exclusion amount that is scheduled to be substantially reduced at some point in the future.

76. Gift Suitability Analysis

Factors to considering if a particular client is a candidate for transfer planning alternatives include the following:

(1) Possibility of future appreciation.

(2) Current cost basis.

(3) Willingness to defend gift tax audit.

(4) Willingness to pay fees to implement gift transactions.

(5) Willingness to give up assets.

(6) Desire to protect assets from future creditors.

(7) Willingness to manage assets actively so that over time there no significant disparity will exist between fair market value and basis of the assets.

(8) Whether gift assets will be sold vs. retained long term.

(9) Knowing that the donor can keep the ability to reacquire the asset for equivalent value and possibly avoid losing a basis step-up at death.

(10) Willingness to pay income taxes on the grantor trust, with the understanding that this obligation can be ended when desired.

77. Overview of Gifting Opportunity Approaches, Particularly for Clients Who Want Some Type of Continued Access to Gift Assets

The following is a list of gifting approaches, in order of increasing aggressiveness and/or complexity, particularly for clients who want some type of continued access to gift assets.

a. **Annual Exclusion/Tuition Gifts.** Gifts up to the gift tax annual exclusion and the tuition and medical expense exclusion. Such gifts could be outright, to custodianships for minors, or to trusts ((§2503(c) trusts or Crummey trusts.)

b. **Traditional Trust Gifts for Descendants (or Other Third Party Beneficiaries).** More significant gifts to trusts with neither the settlor nor settlor's spouse as a present or future possible beneficiary, regardless of any reversal in financial position.

c. **Trust With Settlor's Spouse as Discretionary Beneficiary (Sometimes Referred to as Spousal Lifetime Access Trust, or "SLAT").** Gifts to a trust with the settlor's spouse (and possibly children) as discretionary beneficiaries; at death of the spouse, the assets would be held for descendants.

d. **Trust With Settlor's Spouse as Discretionary Beneficiary (SLAT) or That Might Eventually Include Settlor As Discretionary Beneficiary.** Gifts to a trust with the settlor's spouse (and possibly children) as discretionary beneficiaries; at death of the spouse, the spouse may decide to have all or some of the assets pass into a trust with the settlor as a discretionary beneficiary (depending on whether DAPT legislation or a statute reversing the "relation back doctrine" applies to the continuing trust for the settlor).

e. **Trust With Settlor's Spouse as Discretionary Beneficiary (SLAT) That Eventually Eliminates Spouse As Beneficiary If Spouse's Net Worth Exceeds Specified Amount.** Gifts to a trust with the settlor's spouse (and possibly children) as discretionary beneficiaries; at a predetermined future date, the assets will be distributed outright or in trust for descendants only if the settlor's net worth is at least a specified value determined at the creation of the original trust.

f. **Trust With Settlor as Discretionary Beneficiary (Sometimes Referred to as Domestic Asset Protection Trust, or DAPT).** Gifts to a trust in which the settlor (and others, if desired) are discretionary beneficiaries if DAPT legislation applies to the trust. (Estate inclusion may nevertheless result if the trustee makes frequent distributions to the settlor or the IRS can otherwise establish the existence of a prearrangement that the settlor would receive distributions.)

g. **Trust of Which Third Party Has Power to Add Settlor as Discretionary Beneficiary in the Future.** Gifts to a trust in which others are discretionary beneficiaries, but a third party has the discretion to add the settlor as a discretionary beneficiary after a specified period of time if DAPT legislation applies to the trust. *See* Abigail O'Connor, Mitchell Gans & Jonathan Blattmachr, *SPATs: A Flexible Asset Protection Alternative to DAPTs*, 46 ESTATE PLANNING 3 (Feb. 2019).

h. **Inter Vivos QTIP Trust for Settlor's Spouse.** If estate tax savings are not a concern, gift to an inter vivos QTIP trust for the settlor's spouse, retaining the right to be a discretionary beneficiary if the spouse predeceases the settlor. An inter vivos QTIP trust might also be an alternative for one spouse to make a gift in a way that would utilize the donee spouse's estate exclusion amount.

If a large QTIP exists for a beneficiary, one way of making a large gift to utilize the large gift exclusion amount before it is reduced, but without giving up the right to substantial economic benefits, is to make a §2519 deemed transfer, which is discussed in Item 3.j.(8) of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

i. **Similar But Non-Reciprocal Trusts.** All of the above alternatives might be combined with the settlor's spouse making a gift to a similar, but not identical, trust.

78. Trust for Settlor's Spouse as Discretionary Beneficiary (SLATs); Possible Inclusion of Settlor as Discretionary Beneficiary Following Spouse's Death or at Some Other Time

The settlor may wish to make gifts in a way that the settlor's spouse (or the settlor) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a settlor to make gifts to a "lifetime credit shelter trust" for the benefit of the settlor's spouse (and possibly children). The trust could be designed to give as much control and flexibility as possible to the surviving spouse without creating tax or creditor concerns. The trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the settlor and his or her spouse, but the assets would not be included in the gross estates of the settlor or the settlor's spouse. Such a trust would likely be a grantor trust as to the grantor under §677 (unless the consent of an adverse party were required for distributions to the spouse).

a. **Trust Terms.** The trust would include the settlor's spouse as a discretionary beneficiary, containing very similar terms as a standard credit shelter trust created under a will. The trust may allow very broad control to the spouse but still not be included in the donee-spouse's estate for estate tax purposes and hopefully will be protected against claims of both the settlor's and spouse's creditors. In some ways, this is the ideal kind of trust for the spouse.

Possible terms could include the following:

- The donor's spouse could be a discretionary beneficiary (perhaps with children as secondary beneficiaries or as the primary beneficiaries).
- The spouse could be the trustee (distributions that the spouse could make to himself or herself would be limited to HEMS).
- Provide that no distributions could be made that would satisfy the settlor's legal obligation of support (and if distributions are made to the donee-spouse, preferably the spouse should use those distributions for things other than basic support needs to remove any inference that the funds are actually being used for the settlor's benefit).
- The spouse could have a "5 or 5" annual withdrawal power.
- The spouse could have limited power of appointment (exercisable at death or in life).
- In case the donee-spouse predeceases the settlor, the power of appointment could be broad enough to appoint the assets back to a trust for the settlor. (Exercising the power of appointment in the donee-spouse's will to include the settlor-spouse as a discretionary beneficiary should not cause inclusion in the settlor-spouse's estate under §2036(a)(1) if there was no pre-arrangement, but that might not prevent the settlor-spouse's creditors from being able to reach the trust assets depending on state law (as discussed in Item 78.c below), which itself could trigger estate inclusion for the original settlor-spouse. The power of appointment should provide that it cannot be exercised in a manner that would grant the original settlor a power of appointment over the assets to avoid triggering §2038 inclusion in the settlor's estate. See Item 78.b(2) below.
- A "trust protector" or some independent party could be given the discretion to add the settlor of the trust at some time in the future (perhaps after a number of years or after the donor is no longer married to the donee-spouse or only if the applicable state law has a DAPT statute). Alternatively, a third party could have a power of appointment broad enough to include the settlor as a discretionary beneficiary (which could similarly be subject to conditions, if desired). *See*

Abigail O'Connor, Mitchell Gans & Jonathan Blattmachr, *SPATs: A Flexible Asset Protection Alternative to DAPTs*, 46 ESTATE PLANNING 3 (Feb. 2019). Absolutely no understanding (or even implied agreement) should exist with the protector about how the power would be exercised. Issues regarding a donor as discretionary beneficiary of a trust are addressed in detail in Item 79 below.

- Another way of addressing the case where the donee-spouse predeceases the donor would be to have some life insurance on the donee-spouse payable to the settlor or a trust for the settlor that has substantially different terms than this trust.
- Another way still of addressing a divorce or the donee-spouse predeceasing the settlor would be authorize the trustee to make loans to the grantor. Loans to the settlor are more tax efficient than distributions so that the gift exclusion amount that was allocated to the gift is not wasted, and no interest income will result for loans to the grantor if the trust is a grantor trust.
- If the settlor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the settlor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment.
- To address the possibility of a divorce, in which event the settlor-spouse may not want the donee-spouse to continue as a beneficiary, the trust could define the "spouse" to be the person to whom the grantor is married at the time without causing estate inclusion in the settlor's estate (sometimes referred to as a "floating spouse" approach). *See Estate of Tully Jr. v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§2036(a)(2) or 2038). Therefore, the trust could also be available for the benefit of a new spouse. Also, the settlor and donee-spouse may enter into an agreement that the gift will be taken into consideration in any property settlement incident to a divorce.
- If the settlor gets to the point that the settlor really needs to be a beneficiary of the trust and wants the spouse to exercise the power of appointment, estate taxes may be the least of the settlor's concerns.
- Consider including a tax reimbursement clause but only if, under state law, such clause will not cause the trust to be available to the settlor's creditors. Non-DAPT states with these statutes include Arizona, Florida, Kentucky, Maryland, New Jersey, North Carolina, Oregon, New York, and Texas. *E.g.*, TEX. PROP. CODE §112.035(d)(1) (a settlor is not considered a beneficiary of a trust solely because a trustee other than the settlor "is authorized under the trust instrument to par or reimburse the settlor for, or pay directly to the taxing authorities, any tax on trust income or principal that is payable by the settlor under the law imposing the tax"); s*ee* Rev. Rul. 2004-64.

b. **Application of §§2036-2038 If Donee Spouse (or Other Beneficiary) Appoints Assets Into Trust for Benefit of Original Settlor Spouse.** This issue is receiving increased attention by planners.

(1) **Potential Application of §2036.** If the donee-spouse exercises a testamentary limited power of appointment to appoint the assets into a trust of which the settlor-spouse is a discretionary beneficiary, the IRS might argue that §2036 could apply in the settlor's estate if it could establish an implied agreement that the donee-spouse would leave the donated assets back into a trust for the benefit of the settlor-spouse. This is analogous to situations in which one spouse makes a gift to the other spouse, and the other spouse bequeaths the property back into a trust for the benefit of the original settlor spouse. For a discussion of various relevant cases see Item 5.j(1) of the "2012 Heckerling Musings and Other Current Developments" located **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

A specific exception in the QTIP regulations provides that the §2036/2038 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the settlor spouse. Reg. §25.2523(f)-1(d)(1) & (f) Exs. 10-11. However, those examples would not apply because the rationale in them is that the assets are included in the donee-spouse's estate under §2044.

The possibility of a beneficiary exercising a power of appointment for the benefit of the grantor (or grantor's spouse) applies beyond just SLATs. Trusts for descendants or other beneficiaries may grant a beneficiary a power of appointment broad enough to allow appointing the assets to a trust that may benefit the grantor or the grantor's spouse; the same general issues apply.

The primary issue regarding inclusion in the settlor-spouse's estate under §2036 is whether an implied agreement existed that the power of appointment would be exercised to include the settlor-spouse as a discretionary beneficiary. Prof. Jeffrey Pennell once summarized: "I think, frankly, it would be difficult for the government to make that case, but of course you could leave a trail of documents -- a smoking gun – that could allow the government to say this was all part of a prearrangement, and that conceivably could get you into §2036."

(2) **Potential Application of §2038.** Section 2038 can apply to an ability to alter, amend, revoke, or terminate that exists in the trust at the death of the decedent – it did not have to be retained at the outset. So in exercising the non-general power of appointment, the donee-spouse must be careful not to give the settlor-spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the settlor could not have a testamentary power of appointment by reason of the exercise.

In addition, if creditors can reach the assets in a trust to which assets have been appointed by the donee-spouse under the reasoning of the relation back doctrine (discussed below), that could create a §2038 problem, even if s no implied agreement regarding how the donee-spouse would exercise the power of appointment existed at the time of the original transfer. Although various cases have held that assets in a trust that can be reached by the settlor's creditors are in the settlor's gross estate under §2036 [e.g., *Estate of Paxton v. Commissioner,* 86 T.C. 785 (1986)], some cases have also suggested that inclusion may also result under §2038. E.g., *Outwin v. Commissioner,* 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §2036(a)(1) or §2038(a)(1)).

c. **Creditor Rights Issue.**

(1) **Creditor Concerns If Settlor Becomes Beneficiary of SLAT.** A totally separate issue is that, despite the tax rules, for state law purposes the settlor to the lifetime credit shelter trust may be treated as the settlor of the continuing trust for his or her benefit after the death of the donee-spouse if the settlor-spouse has been added as a discretionary beneficiary. Therefore, for state law purposes, some possibility exists that the trust may be treated as a "self-settled trust" and subject to claims of the settlor's creditors. This would seem to turn on what has been called the "relation back doctrine." The power of appointment is "conceived to be merely an authority to the power holder to do an act for the creator of the power." *Donative Transfers* vol. 2 §§11.1-24.4, in RESTATEMENT (SECOND) OF PROPERTY 4 (1986). Therefore, the donee-spouse, in exercising the power of appointment, is acting for the "creator of the power," so the original settlor-spouse is treated as having made the appointment into a trust for the settlor-spouse's benefit. Little discussion of this doctrine exists, however, in the context of creditor's claims. Barry Nelson observes that "none of the reported cases regarding the Relation Back Doctrine address its application to the settlor of a QTIP or SLAT who receives trust assets upon the death of the donee-spouse through the exercise of a non-general power of appointment."

After discussing the relation back doctrine in this context, one commentator concludes, "Thus, it is not clear that a court would actually hold that it was a transfer from the settlor to a trust for his own benefit through a power holder's discretionary exercise of a power of appointment, but it is a risk." Alexander Bove, *Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined,* 36 ACTEC L.J. 333, 337 (2010). *See also Watterson v. Edgerly,* 40 Md. App. 230, 388 A.2d 934 (1978) (husband gave assets to wife and next day wife signed will leaving assets to trust for husband; held that the trust was protected from husband's creditors under the trust spendthrift clause).

At least eighteen states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust, as opposed to transfers to a lifetime credit shelter trust. Those states include Arizona, Arkansas, Delaware, Florida, Georgia, Kentucky, Maryland, Michigan, New Hampshire, North Carolina, Ohio, Oregon, South Carolina, Tennessee, Texas, Virginia, Wisconsin, and Wyoming. The Arizona, Maryland, Michigan, Ohio, and Texas statutes also address the issue for all inter vivos trusts initially created for the settlor's spouse (including the lifetime credit shelter trust strategy discussed in this subparagraph) where the assets end up in a trust for the original settlor-spouse. *E.g.,* ARIZ. REV. STAT. §14-10505(E-F); OHIO REV. CODE §5805.06(B)(3)(a); TEX. PROP. CODE §§112.035(d)(2) (settlor becomes beneficiary under exercise of power of appointment by a third party), 112.035(g)(1) (marital trust after death of settlor's spouse), 112.035(g)(2) (any irrevocable trust after death of settlor's spouse), 112.035(g)(3) (reciprocal trusts for spouses). For a discussion of and citations to these statutes, see David Shaftel, *Twelfth ACTEC Comparison of the Domestic Asset Protection Trust Statutes*, (August 2019)(to access that excellent summary, go to **www.actec.org** and search for "David Shaftel")).

(2) **Gross Estate Inclusion for Settlor In Light of Creditor Access?** If the settlor's creditors can reach the trust assets, that would cause inclusion in the settlor's estate for estate tax purposes under §2036 if the IRS could establish the existence of an implied agreement that the spouse would exercise the limited power of appointment to appoint the assets into a trust for the settlor's benefit, which creates the creditor's rights problem. However, at least one case (*Outwin v. Commissioner,* 76 T.C. 153 (1981)) also states that §2038 could apply if the settlor's creditors can reach the trust assets, and §2038 does not require an implied agreement of a retained interest at the time the gift is originally made, but only looks to conditions that exist at the settlor's death. Accordingly, it may be important to exercise the limited power of appointment to establish a new trust in a "self-settled trust state" or a state that has passed a law similar to the Arizona, Maryland, Michigan, Ohio and Texas statutes discussed in Item 78.c(1) above. However, even using a "self-settled trust state" for the new trust provides no absolute protection if the settlor does not reside in that state; the settlor's state of domicile may refuse to recognize the asset protection features of the new trust on public policy grounds. The state of the settlor's residence may assert that public policy prevents using an asset protection trust in another state. The conflict of laws issue as to creditor access to trust assets is discussed in detail in Item 79.b below.

(3) **Planning Considerations in Light of Creditor Concerns.** If the state does not have a DAPT statute or a statute negating the "relation back" doctrine, consider not including the original settlor as a discretionary beneficiary directly, but giving a trust protector the power to add (or delete) the original settlor as a discretionary beneficiary.

In addition to avoiding estate inclusion, the trust also provides protection against creditors, elder financial abuse, and identity theft. Over time, the trust can accumulate to significant values (because it is a grantor trust, the client will pay income taxes on the trust income out of other assets) and can provide a source of funding for retirement years.

To maximize the creditor protection feature of SLATs (i) the trustee should have the ability to sprinkle distributions among various beneficiaries, (ii) at least one independent trustee should consent to distributions, (iii) any named trust protector should be someone other than the settlor, and (iv) the trustee should be authorized to permit beneficiaries to use assets (rather than having to make distributions for them to enjoy benefits of the trust).

d. **Gift From One Spouse to SLAT With Split Gift Treatment.** Instead of having each spouse make $10 million gifts, some planners have suggested that one spouse could give the entire $20 million to a trust having the other spouse as a discretionary beneficiary. The other spouse would make the split gift election, which treats him or her as the transferor for gift and GST tax purposes (meaning that the spouse's gift and GST exemption could be used) but NOT for estate tax purposes. Therefore, the assets would not generally be included in the spouse's gross estate for estate tax purposes even though he or she was a discretionary beneficiary. The problem with this approach is that split gift treatment is not allowed if the consenting spouse is a beneficiary of the trust unless the spouse's interest in the trust is ascertainable, severable, and de minimis. *See* Rev. Rul. 56-439, 1956-2 C.B. 605; *Wang v. Commissioner,* T.C. Memo. 1972-143 (no split gift election allowed where consenting spouse's interest in trust receiving gift assets was not ascertainable); *Robertson v. Commissioner,* 26 T.C. 246 (1956) (gift splitting allowed for full amount transferred); *see generally* Diana Zeydel, *Gift-Splitting – A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules,* 106 J. TAX'N 334 (June 2007). Interestingly, Letter Ruling 200130030 allowed gift splitting for the full amount of the transfer without discussing the value [in particular, that it had no value] of the donee spouse's severable interest).

While the *amount* that can qualify for gift splitting may be limited for gift purposes, the regulations appear to provide that if any portion of the transfer qualifies for gift splitting, a full one-half of the transferred amount shall be treated as having been transferred by the consenting spouse for GST purposes. Reg. §26.2652-1(a)(4).

For a more complete discussion of the relevant cases and letter rulings, see Item 5.k.(3) in the December 2012 "Estate Planning Current Developments and Hot Topics" found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

Gift splitting should be allowed in full if:

- Distributions of both income and principal to the donee-spouse are subject to an ascertainable standard of distribution under §2514, preferably a standard based upon the spouse's accustomed standard of living;
- The trustee must consider other resources available to the spouse before exercising its discretion to distribute income or principal to the spouse; and
- The resources that are, and are expected to be, available to the spouse for the remainder of his or her lifetime are sufficient to meet the spouse's living expenses, such that the likelihood that the trustee will need to exercise its discretion to distribute income or principal to the spouse is so remote as to be negligible.

e. **Planning for Complications Arising From Divorce From Spouse-Beneficiary.** The 2017 Tax Act provides that alimony payments will not be deductible and will not be income to the recipient. In addition, §682 is repealed; that section provided that if one spouse created a grantor trust for the benefit of the other spouse, following the divorce the trust income would not be taxed to the grantor-spouse under the grantor trust rules to the extent of any fiduciary accounting income that the donee-spouse is "entitled to receive." The repeal of §682 is particularly troublesome, in part because §672(e) treats a grantor as holding any power or interest held by an individual who was the spouse of the grantor at the time of the creation of such power or interest, so the ex-spouse's interest as a beneficiary arguably might be sufficient to trigger grantor trust status under §677 even following the divorce (but see ACTEC comments filed with the IRS on July 2, 2018 suggesting the possibility of a contrary result).

For an excellent discussion of planning and drafting suggestions for SLATs in light of the repeal of §682, see Laurel Stephenson, *A Second Look at SLATs in Light of the Repeal of I.R.C § 682*, 56 REAL ESTATE, PROBATE, AND TRUST LAW REPORTER (State Bar of Texas Real Estate, Probate and Trust Law Section August 2018). The article suggests that Section 682 might not have been applicable to SLATs providing for discretionary payments to the grantor's spouse because §682 applies to the income of a trust that the spouse "is entitled to receive," and the spouse has no entitlement to the income of a discretionary trust. Planning suggestions include (i) address whether to eliminate or give

some third party the ability to eliminate the grantor's spouse as a beneficiary following a divorce, (ii) negotiate in the divorce for how income taxes will be paid on trust income, and/or (iii) provide for reimbursement of the grantor's income taxes on trust income by a mandate in the trust agreement or at the discretion of an independent fiduciary or in a marital settlement agreement. The amount to be reimbursed may depend on a variety of factors including the distribution standard and whether the spouse will likely receive a distribution of all trust income following a divorce. For a trust with other discretionary beneficiaries, the trustee might make distributions to beneficiaries other than the ex-spouse; the trust would still be a grantor trust but at least no income distributions would benefit the ex-spouse. Other commentators have discussed planning considerations as well in light of this important change. George Karibjanian, Richard Franklin & Lester Law, *Alimony, Prenuptial Agreements, and Trusts Under the 2017 Tax Act*, BNA ESTATES GIFTS & TRUSTS J. (May 10, 2018); Justin Miller, *Tax Reform Could Make Divorce a Lot More Taxing*, ACTEC 2018 FALL MEETING SEMINAR (2018).

Prior to its repeal, §682 did not define "income" or clarify whether it refers only to fiduciary accounting income or also includes capital gains. If capital gains are not distributed to the spouse, §682 probably did not apply to them. If capital gains are allocated to income or are included in DNI and are distributed to the spouse, §682 likely does apply. *See* Barry Nelson & Richard Franklin, *Inter Vivos QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce*, LISI ESTATE PLANNING NEWSLETTER #2244 (Sept. 15, 2014).

The repeal of §682 not only suggests changes when drafting SLATs, but also increases the importance of involving estate planning advisers in divorce planning. George Karibjanian, Richard Franklin & Lester Law, *Alimony, Prenuptial Agreements, and Trusts Under the 2017 Tax Act*, BNA ESTATES GIFTS & TRUSTS J. (May 10, 2018)

f. **Special Planning Considerations for SLATs.**

- Avoid the reciprocal trust issue by making only one spouse a beneficiary, at least initially.
- Using a SLAT prevents gift splitting if the spouse's interest is not severable, ascertainable, and de minimis (see Item 78.d above)
- The SLAT provides a benefit only while the donee-spouse is living and married to the grantor.
  - Consider an agreement of the spouses that the gift will be taken into consideration in any property settlement incident to a divorce.
  - Consider life insurance on the donee-spouse in case the donee-spouse dies before the grantor.
  - Give the donee-spouse a limited testamentary power of appointment exercisable in favor of the grantor (but carefully consider §2036 and creditors' rights against the settlor before the donee-spouse exercises the power of appointment).
  - The grantor may exercise a power of substitution (e.g., for a long-term AFR note) if the parties divorce so that the settlor would have the ability to re-acquire favored assets in the trust.
- The step transaction doctrine may treat the donee-spouse as a grantor if transfers were made by the donee-spouse to the grantor shortly before the grantor funded the trust.
- If the SLAT is funded by the grantor with a residence, can the grantor reside in the residence without paying rent? (Presumably yes, under the reasoning of various §2036 cases that a settlor's continuing to live with his spouse is not considered an implied agreement of retained enjoyment.) If the settlor pays rent, is it a gift? (Presumably not.)

- The various planning considerations discussed for DAPTs in Item 79.e below also apply for the trust with respect to provisions about adding the settlor as a discretionary beneficiary. For example, use the laws of a DAPT state, or at least use the laws of a state with favorable legislation negating the "relation back" doctrine to help resolve the creditor issue (which, in turn, is an estate tax issue if the SLAT assets are appointed to a trust for the settlor's benefit).

79. Trust for Settlor as Discretionary Beneficiary (DAPT); Possible Inclusion of Settlor as Discretionary Beneficiary at Some Later Time

A settlor might create a trust naming the settlor directly as a discretionary beneficiary, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities occur, without triggering §2036(a)(1) (a transfer with an implied agreement of retained enjoyment). This only works, though, if local law does not allow the settlor's creditors to reach the trust as a result of the settlor's status as a beneficiary (or else the gift would not be a completed gift and the assets would be included in the settlor's gross estate for estate tax purposes, as discussed in Item 79.d below). Self-settled trusts (sometimes referred to as domestic asset protection trusts, or DAPTs) may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors. The state law issue about creditor access is vitally important if the settlor is named directly as a discretionary beneficiary, and this creditor access issue is discussed in some detail below before discussing the tax effects and planning considerations for DAPTs.

a. **Domestic Asset Protection Trust (DAPT) Statutes – Overview.** Alaska was the first state to adopt domestic asset protection trust (DAPT) legislation 22 years ago, providing that a settlor's creditors would not be able to reach trust assets merely because the settlor was a discretionary beneficiary of the trust, if the trust met certain requirements. (Missouri practitioners point out that Missouri had DAPT legislation before Alaska, but dicta in a bankruptcy case undermined confidence in the statute.) Some form of DAPT legislation now exists in 19 states (the two newest states are Indiana and Connecticut): Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming. Those 19 states cover over 20% of the United States population. Nine additional states have recognized some limited version of self-settled trust creditor protections, such as for inter vivos spousal QTIP trusts that may remain in trust for the benefit of the original settlor after the spouse's death.

   For an excellent summary of the 19 DAPT statutes, see David Shaftel, *Twelfth ACTEC Comparison of the Domestic Asset Protection Trust Statutes* (updated through August 2019)(to access that excellent summary, go to **www.actec.org** and search for "David Shaftel").

   A significant uncertainty about DAPTs is the extent to which a resident in a state that does not have DAPT legislation can create a trust under the laws of a DAPT state and still enjoy protection of the spendthrift clause. To date, no case has recognized protection against the non-resident settlor's creditors. Various cases (some of which are discussed below) have not recognized protection, but they have generally involved egregious fraudulent transfers that would not be allowed protection under the state DAPT statute in any event.

   Comment 8 to §4 of the Uniform Voidable Transactions Act (UVTA) suggests that transferring assets from a non-DAPT jurisdiction to a self-settled trust in a DAPT jurisdiction would be a voidable transaction and would not be entitled to spendthrift protection. For further discussion about Comment 8 and the UVTA, see Items 48-50 of the ACTEC 2017 Fall Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

b. **Conflict of Laws Issues; Especially Important If Settlor in One State Creates a DAPT Under Another State's DAPT Laws.** A primary issue that has arisen in cases addressing DAPTs is the conflict of laws issue as to whether the law of the DAPT state where the trust is sitused or the laws of the debtor's state will apply. For example, *Waldron v. Huber (In re Huber)*, was a bankruptcy case concluding that Washington (the debtor's state) had a strong public policy against asset protection for self-settled trusts and applied the law of Washington rather than Alaska. *In re Huber*, 2013 WL 2154218 (Bankr. W.D. Wash. 2013) (Washington real estate developer created Alaska asset

protection trust in 2008 when he was aware of the collapsing housing market and that his prospects for repaying loans was fragile at best; trust was found to be a fraudulent transfer voidable under both §544(b)(1) [state law fraudulent transfers] and §548(e) [transfer made within 10 years of filing petition for bankruptcy to a self-settled trust or similar device if made with actual intent to defraud creditors]; trust also held invalid under conflict of laws analysis because even though the choice of law designated in the trust is upheld if it has a substantial relation to the trust considering factors such as the state of the settlor's or trustee's domicile, the location of the trust assets, and the location of the beneficiaries, in this case the trust had its most significant relationship with Washington and Washington has a strong public policy against self-settled "asset protection trusts," citing §270 of Restatement (Second) of Conflict of Laws).

Section 270 of the Restatement (Second) of Conflict of Laws states: "An inter vivos trust in movables is valid if valid under the law of the state designated by the settlor to govern the validity of the trust, provided that the application of its law does not violate a strong public policy of the state with which the trust has its most significant relationship." In *Huber*, the court determined that Washington, not Alaska, had the most substantial relationship to the trust by looking at various factors. Section 273 of the Restatement addresses immovables and does not include the strong public policy exception, but the court did not even mention §273.

In *Wells Fargo v. Retterath*, 928 N.W.2d 1 (Iowa 2019), the Iowa Supreme Court addressed the validity of a charging order against an Iowa LLC that was created by Florida residents. If Florida law applied, the LLC interest would be tenancy by the entireties property and not available to satisfy debts of one of the tenants individually. While the title of intangible assets will normally be based on the law of the domicile of the owners, the law of the jurisdiction where an LLC is located should be applied regarding the enforceability of a charging order against the LLC. That state is the state with the "most significant contacts."

Another example of a case that raises concern about trying to rely on laws of a jurisdiction outside the state of the settlor-beneficiary's residence is *Rush University Medical Center v. Sessions*, 2012 Ill. 112906 (2012), in which the Illinois Supreme Court held that a decedent's creditors could reach assets that had been transferred to a Cook Islands trust. That case involved an egregious fact situation in which an individual transferred almost all of his assets to a Cook Islands trust of which the settlor was a discretionary beneficiary, knowing that he had made a large charitable pledge and that his remaining assets would not be sufficient for his estate to satisfy the pledge. The court did not address which jurisdiction's law should apply under relevant conflict of laws principles, but held that the state's passage of a fraudulent conveyance statute did not supersede Illinois common law principles allowing the creditors of a settlor to reach trust assets to the extent that the trust assets could be distributed to the settlor. In *Rush University*, the Cook Islands trust owned real estate in Illinois that had sufficient value to satisfy the judgment, so apparently there was no issue about having to enforce the judgment in the Cook Islands.

Another case that limited the effectiveness of an Alaska DAPT against a creditor from the settlor's state, but did not discuss the conflict of laws issues, is *Toni I Trust v. Wacker*, 413 P.3d 1199 (Alaska 2018). The facts are outrageously egregious, but the Alaska Supreme Court ultimately held that an Alaska statute cannot bar a Montana creditor from bringing a claim under Montana law against a Montana debtor over property located in Montana, just because the property had been assigned to an Alaska trust. The court held that the exclusive jurisdiction provision in the Alaska DAPT statute is unconstitutional. For a more detailed discussion of the *Toni I Trust* case, see Item 28.b. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

See also In re Rensin (Bankruptcy Court held that Cook Islands trust, of which grantor was the primary beneficiary, was subject to Florida law as a matter of public policy); *In re Herbert M. Zukerhorn,* BAP No. NC-11-1506, U.S. Bankruptcy Appellate Panel of the Ninth Circuit (Dec. 19, 2012) (dictum).

c. **Full Faith and Credit.** No case has yet addressed whether a judgment in one state will be entitled to "full faith and credit" in an enforcement against a DAPT in another state (a DAPT state) where the trust is located. A similar issue was raised, though, in *In the Matter of Cleopatra Cameron Gift Trust*, which reasoned that the Full Faith and Credit Clause does not apply to the manner for *enforcing* judgments of another jurisdiction. See Item 17 of Heckerling Musings 2020 and Estate Planning Current Developments (March 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** for a more detailed discussion of the *Cleopatra Cameron Gift Trust* case, including a discussion of whether the court has personal jurisdiction over the trustee.

d. **Transfer Tax Consequences of DAPTs.**

(1) **Completed Gift.** Cases have recognized that transfers to trusts can be completed gifts, even if the settlor is a potential discretionary beneficiary, if the settlor's creditors cannot reach the trust. *E.g.*, *Outwin v. Commissioner*, 76 T.C. 153, 162-65 (1981) (gift to trust incomplete if creditors can reach trust assets); *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941) (gift to trust is completed gift if state law provides that settlor-beneficiary's creditors could not reach the trust corpus or income).

The IRS has acknowledged that a transfer to a DAPT can be a completed gift even though the asset may be distributed back to the settlor in the trustee's discretion. Rev. Rul. 76-103 ("If and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rule set forth in §25.2511-2"). *See also* PLRs 200944002, 9837007, & 9332006, discussed immediately below regarding estate inclusion.

(2) **Estate Inclusion.** If a grantor makes a transfer and retains the right to the income from the property or the property itself, §2036 may cause estate inclusion of the transferred asset. Several cases have held that the ability of a settlor's creditors to reach the assets will be deemed to be retained use and enjoyment of the transferred assets for purposes of §2036. (*Paxton v Commissioner, German Estate v. U.S., Outwin Estate v. Commissioner, Paolozzi v. Commissioner*). As discussed in Item 78.b(2) above, §2038 may also apply. For further discussion of those cases and §2036 issues surrounding the use of self-settled trusts, see Item 5.l of the December 2012 "Estate Planning Current Developments and Hot Topics" found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

Several IRS private rulings have discussed whether §2036 will apply if the trustee has the discretion to make distributions to the settlor but state law does not permit the settlor's creditors to reach the trust assets under a DAPT statute. Letter Ruling 9332006 involved a transfer to a foreign trust, and the ruling concluded that the transfer was a completed gift and that assets were not included in the settlor's gross estate. In Letter Ruling 9837007 the IRS expressly refused to rule that whether assets in an Alaska DAPT would be excluded from the settlor's estate, presumably because the IRS viewed that determination as dependent upon the facts and circumstances existing at the settlor's death.

Letter Ruling 200944002, which also addressed an Alaska DAPT, similarly refused to rule as to whether the trustee's discretion to distribute trust assets to the settlor, when combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement), may cause inclusion in the settlor's gross estate under §2036. Letter Ruling 200944002 recognized that "the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036." However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under §2036." The PLR cited the tax reimbursement revenue ruling, Rev. Rul. 2004-64, which ruled that a trustee's discretion to reimburse a grantor for income taxes attributable to grantor trust income, would not by itself constitute a retained interest causing

inclusion under §2036, but other facts, combined with the settlor's possibility of receiving tax reimbursement payments, could cause estate inclusion if (i) an understanding or prearrangement existed as to how the trustee would exercise such discretion, (ii) state law subjected the trust assets to claims of the settlor's creditors, or (iii) the settlor retained the power to remove and replace the trustee with someone related or subordinate. Beginning in late 2011, the IRS has informally told other parties requesting similar rulings that it is not willing to issue further similar rulings.

(3) **Effect of Lingering Temporary Potential Creditor Access.** DAPT statutes typically allow pre-existing creditors to reach trust assets if the gift to the trust was a fraudulent conveyance, and also allow certain "exception creditors" (such as for alimony, child support, property division, and sometimes tort claims in existence before the funding of the trust) to reach trust assets, with limitations on the timing and amount of such claims.

Under the Uniform Voidable Transactions Act, "voidable transfers" can be reached by creditors within the time specified in the statute, and future creditors may set aside transfers made with actual intent to hinder, delay or defraud the creditor within one year following their discovery of the transfer (known as the "discovery period").

In addition, all DAPTs are subject to the federal bankruptcy law clawback if the settlor files bankruptcy within 10 years of funding a DAPT.

Does the possibility of a creditor being able to reach the assets mean that the gift is incomplete and estate inclusion results until the period of such contingencies has passed? The IRS reportedly has informally expressed some concern with issuing further rulings about Alaska DAPTs because of the bankruptcy clawback provision. According to counsel, the Service appears to be troubled by commentary about the *Mortensen* Alaska bankruptcy case. *Battley v. Mortensen*, Adv. D.Alaska, No. A09-90036-DMD (2011) allowed the bankruptcy trustee to recover assets transferred to an Alaska "self-settled trust" under the 10-year "clawback" provisions of §548(e) of the Bankruptcy Code. Personnel at the Service reportedly said that PLR 200944002 probably wouldn't have been issued if they were looking at it now and that the Service since has declined other Alaska ruling requests.

Presumably, such contingencies for a settlor's creditors to reach assets in DAPTs do not cause incomplete gift treatment or estate inclusion. (Indeed, ALL gifts could be subject to such treatment in case the gift turned out to be a fraudulent transfer.) Planners are unaware of any case in which the IRS has argued that these contingencies cause a gift to be incomplete or cause estate inclusion. Even so, as to the 10-year clawback Bankruptcy Code provision, consider using a jurisdiction in which the DAPT statute provides that the DAPT restrictions are enforceable under nonbankruptcy law of the state so that the clawback provision in the Bankruptcy Code would not apply. (States with DAPT statutes that are enforceable under nonbankruptcy law are Connecticut, Missouri, Nevada, Virginia, and West Virginia.)

e. **Planning Considerations for Minimizing Incomplete Gift and Estate Tax §2036 Concerns.** Set expectations with the client that these trusts are not 100% fool proof as to the incomplete gift argument or the §2036 estate inclusion issue.

(1) **Use Laws of DAPT State.** Creating the trust under the laws of a self-settled trust state is essential if a self-settled trust is being created. If the settlor is not a resident of a DAPT state, whether incorporating the law of a DAPT state will work is uncertain.

(2) **"Springing DAPT;" Settlor Not a Current Beneficiary But Third Person With Power to Add Settlor as Discretionary Beneficiary; "SPATs."** Use a "springing DAPT," a trust in which others are discretionary beneficiaries, but a third party has the discretion in a non-fiduciary capacity to add the settlor (or alternatively "any descendant of the settlor's grandparents") as a discretionary beneficiary after a specified period of time, but to be most conservative, the provision would add that the settlor could be added only if DAPT legislation applies to the trust. *See* Abigail O'Connor, Mitchell Gans & Jonathan Blattmachr, *SPATs: A Flexible Asset Protection*

Alternative to DAPTs, 46 ESTATE PLANNING 3 (Feb. 2019). (An inter vivos power of appointment in a non-adverse party would cause the trust to be a grantor trust.)

(3) **Power to Remove Settlor as Beneficiary.** A third party could have the power to remove the settlor-spouse as a beneficiary (if the settlor has been added as a beneficiary at some point). That power could be exercised when the settlor is near death. Whether a retained enjoyment exists under §2036 is tested at the moment of death, and §2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as no prearrangement exists). *See* Tech. Adv. Memo. 199935003 (§2035 will apply if pre-planned arrangement). One panelist observes that most clients will not be comfortable with some third party having the power to remove them as a discretionary beneficiary.

(4) **Avoid Distributions to Settlor as Beneficiary Unless Absolutely Needed; Inherent Pre-Arrangement/Implied Agreement Issue; Consider Loans or Splitting Trusts.** A §2036 concern may arise if the settlor ever needs distributions from the trust and distributions are made to the settlor. That might give rise to at least an argument by the IRS of a pre-arrangement or implied agreement that distributions would be made when requested. Of course, if the settlor gets to the point of needing distributions from the trust, estate tax concerns may be the least of the settlor's worries.

Consider making loans rather than distributions to the settlor-beneficiary. Charge interest and treat the loan as a bona fide loan. (Because the trust is a grantor trust, the interest paid by the settlor to the grantor trust will not be taxable income.)

If distributions must be made to the settlor from the trust, consider splitting the trust (decanting, nonjudicial settlement agreement, judicial modification, trust protector modification, etc.) into two trusts, one of which permits discretionary distributions to the settlor and the other of which does not. The §2036 risk might then exist only as to the continuing trust of which the settlor is a discretionary beneficiary.

(5) **Power to Add Settlor-Spouse as Discretionary Beneficiary Only if "Act of Independent Significance" Exists.** Provide that an independent third party (such as a trust protector could add the settlor as a discretionary beneficiary only upon the occurrence of an "act of independent significance," such as the death of the settlor's spouse or the settlor's net worth falling under a dollar amount (that is far less that the settlor's current net worth). That could help establish the absence of any "retained" benefit includable under §2036.

(6) **After No Longer Married.** Consider, for married clients, excluding the settlor as a beneficiary as long as he or she is married. (This is a corollary of the preceding paragraph, *if* divorce is considered as an act of independent significance. A "contrived" divorce may not succeed for this purpose, but any divorce could have significant adverse tax effects, such as the loss of an estate tax marital deduction, so divorce may be viewed in particular circumstances as an act of independent significance.)

(7) **Settlor Cannot Be Added as Discretionary Beneficiary For At Least Ten Years.** Consider providing that the power to add the settlor as a discretionary beneficiary could not be exercised for at least ten years from the last funding of the trust. This addresses any concern with respect to an open period of limitations under §548(e) of the Bankruptcy Code.

(8) **Trustee Selection.** The trust must have at least a resident trustee in the state whose DAPT laws are being used, but the settlor could appoint others (e.g. advisory committee) to make investment or distribution decisions. The trustee should not be related or subservient to the settlor.

(9) **Trust Protector.** A trust protector (who should be a non-adverse party) can have the power to discharge trustees, make certain trust amendments if necessary, the power to add the settlor as a discretionary beneficiary, etc.

(10) **Change of Situs.** A change of situs provision allows for subsequent changes if laws or circumstances change.

(11) **General Asset Protection Provisions.** Other asset protection provisions such as anti-duress clauses and flee clauses can be incorporated into the trust.

(12) **Termination Power.** Termination powers could be given to the trustee or a trust protector if continuation of the trust is not in the settlor-beneficiary's best interests.

(13) **Spendthrift Provision.** Include a spendthrift provision to protect trust assets from the beneficiary's creditors/former spouses.

(14) **Combination with Separate Entity.** An asset protection trust can be combined with a limited partnership or limited liability company in order to permit investment management and control of the trust assets to continue in the settlor without jeopardizing the nature of the transfer as a completed gift.

- **Discount Planning.** The structure may provide lack of marketability and lack of control discounts on the transfer of limited partnership/membership interests to the trust, thereby permitting the transfer of real value in excess of the amount subject to taxation.
- **Separate Entity Structure Adds Another Layer of Protection.** Using a separate entity structure will provide an additional layer of protection between third party creditors and the trust.
- **Charging Order as Only Remedy?** In the unlikely event of trust creditors, enforcement of a judgment will be limited to a charging order against the trust's limited partnership or limited liability company interest if the trust assets are owned in an entity.
- **Increased Contacts with State.** Use of a limited partnership or limited liability company formed in the DAPT state will increase the settlor's contacts with that state, further justifying the application of that state's law to the claims of any creditor of the settlor.

(15) **Other Split Interest Trusts Following Trust Term.** An asset protection trust can be combined with any split-interest gift in trust (*i.e.*, a QPRT, GRAT, or CLT), in order that the settlor may continue to have discretionary access to the transferred property after the initial term of the trust has expired.

(16) **Life Insurance on Settlor's Life.** An asset protection trust can be used to own the settlor's life insurance policies in the same manner as an irrevocable life insurance trust. So long as the settlor does not retain incidents of ownership in the transferred policies he can be a discretionary beneficiary, thereby permitting distributions of cash value to the settlor. *See* PLR 9434028.

80. Multiple "Non-Reciprocal" Trusts

a. **Preferable If Only One Spouse Creates SLAT; Other Spouse Creates Trusts for Others.** If clients are concerned about having enough retained assets as a "rainy day" fund in case of unexpected severe financial reverses, hopefully that concern can be accommodated by having only one spouse make a gift to a trust with the other spouse as a discretionary beneficiary. The gift by the other spouse would be to a trust with only descendants as beneficiaries, and that clearly avoids the reciprocal trust doctrine (although an issue could arise if the spouses serve as trustees of each other's trust).

b. **Both Spouses as Beneficiaries of Trust Created by Other Souse; Reciprocal Trust Concern.** Some clients may want to go further and have each of the spouses create SLATs for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. *United States v. Grace*, 395 U.S. 316 (1969). In *Grace*, the trust terms were identical, the trusts were created 15 days apart, and the trusts were of equal value. The Court reasoned:

> Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the *trusts be interrelated,* and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the *same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries. (Emphasis added)

If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Commissioner,* 46 T.C.M. 910 (1983); PLR 200426008; *but see Estate of Green v. United States,* 68 F.3d 151 (6th Cir. 1995) (Jones, J. dissenting).

c. **Possible Distinctions to Avoid Reciprocal Trust Doctrine.** Possible distinctions that could be built into the trusts include the following.

- Create the trusts at different times (separated by months, not 15 days as in *Grace*).
- Fund the trusts with different assets and different values (observe that *Grace* holds that just having different assets is not sufficient to avoid the doctrine, but it applies only to the extent of mutual value, *Estate of Cole v. Commissioner,* 140 F.2d 636 (8th Cir. 1944)).
- One trust allows distributions without any standard but the other trust imposes a HEMS standard.
- One trust might require considering the beneficiary-spouse's outside resources and the other would not.
- One of the spouses would become a discretionary beneficiary only after the lapse of some specified time (say, 5 years) or on the occurrence of some event. For example, Letter Ruling 200426008 addresses trusts under which (i) husband would not become a beneficiary of wife's trust until three years after wife's death and then only if the husband's net worth did not exceed a specified amount and his income from personal services was less than a specified amount, and (ii) wife had a "5 or 5" power of withdrawal from husband's trust after their son's death.
- One trust includes the settlor's spouse as a discretionary beneficiary but the other trust would merely give an independent party, perhaps after the passage of some specified time, the authority (not exercisable as a fiduciary) to add that settlor's spouse as a discretionary beneficiary.
- One trust allows conversion to a 5% unitrust but the other trust prohibits that.
- Provide different termination dates and termination events.
- Provide for different remainder beneficiaries upon termination of the trusts.
- Include an inter vivos power of appointment in one trust and not the other (like in *Levy*).
- Utilize different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees or perhaps in one trust the power is exercisable only with the consent of a non-adverse party).
- Use different trustees.
- Structure different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party).

d. **Spouses as Secondary Beneficiaries.** There may be an advantage to making the primary beneficiary the settlors' children and/or grandchildren, and including each other only as secondary beneficiaries.

e. **Differences Must be "Real."** In any event the differences need to be "real." Additionally, the structure of the trusts is only part of the equation, and probably not the most important part. How the trusts are *administered after they are created* may be the most critical factor. Clients may want to make gifts to the trusts and then immediately start flowing cash out of the trusts to each other the same as they did before the trusts were created. If that is done, the IRS would likely argue the existence of a pre-arranged plan that the income or other benefits would come right back to the grantor, even if only indirectly through the spouse.

f. **Spouses Not Reciprocal Trustees.** Consider not having each of the spouses serve as trustee of the other's trust. Reciprocal dispositive powers may be sufficient to invoke the reciprocal trust doctrine if the trusts are sufficiently interrelated; reciprocal economic interests may not be required. *See Bischoff v. Commissioner,* 69 T.C. 32 (1977); *Exchange Bank & Trust v. United States*, 694 F.2d 1261 (Fed. Cir. 1982).

For a more complete discussion of the reciprocal trust doctrine, authorities holding that the reciprocal trust doctrine does not apply if there are substantial differences between trusts, authorities for applying the doctrine to reciprocal powers, and related creditors' rights issues see Item 5.I of the December 2012 "Estate Planning Current Developments and Hot Topics" found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

g. **Creditors' Rights Issue?** A possible concern with "non-reciprocal" trusts by each of the spouses for each other is that they may not be respected for state law purposes with respect to claims of creditors against the settlors*. Cf. Security Trust Co. v. Sharp*, 77 A.2d 543 (Del. Ct. Ch. New Castle 1950) (case did not involve a creditor attack on a reciprocal trust, but suggested in dictum that reciprocal trusts would be subject to attack by creditors). The *Security Trust* case was over 60 years ago, and locating any reported case in which creditors have attacked a reciprocal trust under this theory is difficult.

State legislatures may address this issue. For example, Arizona and Texas statutes provide protection from a reciprocal trust attack when spouses create trusts for each other. ARIZ. REV. STAT. §14-10505(E); TEX. PROP. CODE §112.035(g)(3).

The possibility of creditors attacking reciprocal trusts should not be a problem if the trusts are created under the laws of states that have adopted DAPT provisions (as discussed in Item 79.a above).

If the settlors' creditors can reach the trust assets, that would cause inclusion in the settlors' estates for estate tax purposes under §2036 (and possibly under §2038).

81. GST Planning Considerations

a. **Cannot Ignore GST Tax.** Even low-to-moderate wealth individuals cannot ignore the GST tax. Without proper allocation (either automatically or manually) of the GST exemption (currently $10 million indexed), trusts created by clients generally will be subject to the GST tax (currently 40%) at the death of the beneficiary unless the trust assets are included in the beneficiary's gross estate.

b. **Making Use of Large GST Exemption While It Exists.** Grantors who have previously created irrevocable trusts that are not fully GST-exempt may want to allocate some of the increased GST exemption amount to the trust. The Bluebook for the 2017 Tax Act (published in December 2018 about a year after the Act was passed) has a detailed footnote saying that is permitted, and the preamble to the anti-clawback final regulation suggests that the IRS agrees. Allocating GST exemption to remainder trusts created after a GRAT terminates may be especially beneficial since GST exemption cannot be allocated to a GRAT until the end of the ETIP.