BESSEMER TRUST

ACTEC 2020 Fall Meeting Musings

October 2020 Meeting

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 Fall Meeting and does not purport to represent the views of ACTEC as to any particular issues.

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Table of Contents

Introduction 2

Items 1-7 are observations from the seminar at the Summer Meeting: Heartbroken, or Just Broken? How Trusts Fare in a Divorce 2

1. Significance of Considering Divorce in Trust Planning 2
2. Structuring Third-Party Trusts for Maximum Divorce Protection 2
3. Review of Pre-Existing Trusts; Other Drafting and Operational Considerations 4
4. Spendthrift Exceptions 5
5. Massachusetts Experience 5
6. Governing Law Issues 6
7. Grantor Trust Taxation Issues Following Divorce 8

Items 8-11 are observations from the seminar at the Fall Meeting: Community Property Tips and Traps for Practitioners in Common Law States 9

8. What is Community Property? 9
9. Significance of Characterization of Property as Separate or Community Property 12
10. General Impact on Marital Property of Migrating Between Community and Noncommunity Law States 13
11. Planning Strategies for Migrating Clients 16

Items 12-19 are observations from the seminar at the Fall Meeting: Managing Your Law Practice in the New Normal and Beyond 17

12. Treasure Trove of Resources 17
13. Business and Staff Management 17
14. Work/Life Balance 18
15. Client Development and Management 18
16. Drafting and Managing Client Instruments 18
17. Ethical Rules Impacted by Technology 19
18. Technology Security 20
19. Remote Working in Another State 20

Items 20-26 are observations from the seminar at the Fall Meeting: Art Law 21

20. Unique Challenges of Planning With Art 21
21. Collection Management Practices 21
22. Planning Options for Disposition of Art 23
23. Top Ten Planning Pointers 26
24. Auction House Sales and Policies 27
25. Art Litigation Issues 28
26. Resources 29

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Introduction

Some of my observations from the 2020 ACTEC Fall (Virtual) Meeting Seminars on October 26-29, 2020 are summarized below. The seminars were available online to meeting registrants. (At the request of ACTEC, the summary does not include any discussions at Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely includes selected issues. The summary is based on the presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-7 are observations from the seminar at the Summer Meeting: Heartbroken, or Just Broken? How Trusts Fare in a Divorce by Amy J. Kanyuk, Melissa Langa, David Pratt, and Adam F. Streisand

1. Significance of Considering Divorce in Trust Planning

Even if things are loving in a non-economic way at the beginning of a marriage, things will be neither loving nor non-economic at the end of a marriage by divorce. It is then all about money. Trusts can be structured in a way to assist in protecting trust assets (and thereby protecting) a beneficiary in protecting the trust assets in the event of a divorce. Applicable issues in a divorce action are whether trust assets are marital property that can be awarded to either spouse in the divorce or are assets available to a beneficiary that the court can consider in determining what other assets are to be awarded to the beneficiary's ex-spouse. Laws regarding creditor rights come into play (the claim of a beneficiary's ex-spouse against the beneficiary is a type of creditor claim), but special rules are even more protective of the claims of spouses than of general creditors.

2. Structuring Third-Party Trusts for Maximum Divorce Protection

a. **General Caveats.** The law regarding rights to trust assets on a beneficiary's divorce is unsettled and varies throughout the states.

Family law judges and attorneys generally are not trust law experts, and a trust should be drafted to be as explicit as possible as to issues with which a judge may be unfamiliar.

A complexity is that the attorney structuring a trust for a client will not know where a trust beneficiary may live at the time of a divorce. The planner must structure the trust for maximum protection wherever a beneficiary may live.

Planners cannot guarantee that trust assets will be completely safe from the claims of beneficiaries' spouses in divorce actions. The summarized drafting techniques may give trust beneficiaries the greatest chance of succeeding against a claim to trust assets by a divorcing spouse of a beneficiary.

For general planning issues about the effect of trust structuring to provide protection of a beneficiary's discretionary interest in a trust for divorce purposes, see Item 4.k of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Avoid Mandatory Distributions or Withdrawal Rights.** If a beneficiary can, as a matter of right, access trust property, the beneficiary's creditors can access that property as well (either directly from the trust or from the beneficiary). Mandatory distribution rights can be considered as available to the beneficiary in a divorce action even if the beneficiary is not *currently* entitled to the distribution at the time of the divorce. For this reason, avoid staged mandatory distribution rights as the beneficiary reaches certain ages. Similarly avoid giving the beneficiary withdrawal powers, including "5 or 5" powers or Crummey withdrawal rights.

This may present a balancing issue for some clients who may wish to grant such rights to their beneficiaries but may decide not to include these rights if the client wants to maximize divorce protection for beneficiaries.

c. **Fully Discretionary Trusts.** Trustees should be authorized to make distributions in their sole and absolute discretion. Avoid ascertainable standards that an ex-spouse could argue are enforceable to force trust distributions to a beneficiary (to be treated as marital property that could be divided in a

divorce). A judge may not understand the niceties of whether the ascertainable standard merely modifies the fully discretionary distribution provision or whether it creates property rights.

If a client wishes to provide some guidance as to how the discretion should be exercised, consider using non-binding precatory language to encourage, but not direct, distributions for specified purposes. Furthermore, the planner may consider including statements regarding the grantor's intent in a side "letter of wishes" (but little law exists regarding the consequences of having such a letter – does it effectively become part of the trust agreement and is it discoverable?). If the trust agreement already exists, a letter of wishes may be the only alternative available for the grantor to express the grantor's intent regarding the trust.

A trust might specifically discourage distributions if the trustee thinks that a distribution would not be in the best interest of the trust beneficiary.

d. **Actual Distributions.** Even if a fully discretionary standard is used, a divorce court may treat the right to distributions as a property right (and therefore marital property) if the trustee follows a regular pattern of distributions. And even if the court does not view a pattern of regular distributions as creating marital property, a court may consider anticipated future distributions in determining how other marital assets will be divided between the spouses.

e. **Multiple Beneficiaries.** Use multi-beneficiary trusts to further distance the rights of any particular beneficiary to trust assets. Authorize distributions to some, all, or none of the beneficiaries in disproportionate amounts. Specifically waive the trustee's duty of impartiality among beneficiaries. To go even further, the class of beneficiaries may be subject to expansion (e.g., future unborn descendants) or the trust might authorize someone, acting in a non-fiduciary capacity, to expand the class of permissible discretionary beneficiaries. (Again, this suggestion of using "pot" trusts for multiple beneficiaries may conflict with a goal generally of not forcing family members to "share" trusts in order to avoid family conflicts, and the client will need to weigh which approach to use.)

f. **Limited Powers of Appointment.** The existence of a limited power of appointment generally does not expose assets to a powerholder's creditors. A beneficiary (or other persons) could be given an inter vivos limited power of appointment to appoint trust assets to a limited class of persons. In the event of a divorce, the trust property could be re-directed. (Be aware that giving someone other than an adverse party an inter vivos power of appointment may cause the trust to be a grantor trust under §674.)

g. **Expressly Negate Property Rights and State that Non-Beneficiaries Have No Rights.** A trust might specifically state that a beneficiary's interest in the fully discretionary trust is not a property right but a mere expectancy, in case applicable state law does not expressly provide that result.

A trust provision might state expressly that (i) the grantor's intent, and a material purpose of the trust, is that the trust property is available only to trust beneficiaries, to the absolute exclusion of any other individual, including a beneficiary's spouse or ex-spouse, and (ii) the trust property should not be treated as marital property.

Such explicit statements in the trust agreement may be persuasive in convincing a divorce judge, who may be only generally familiar with trusts, not to treat trust assets as marital property. (Some planners now refer to these types of clauses as "Pfannenstiehl clauses.") See Item 5.a below for a summary of the *Pfannenstiehl* case.

h. **Include Spendthrift Provision.** If a trust agreement has no mandatory distribution or withdrawal rights, a spendthrift provision may be unnecessary, because no property rights are created. But include a spendthrift provision to make clear (and convince the divorce judge) that creditors have no access to trust assets (even if an exception from spendthrift protection may ultimately apply, as discussed in Item 4 below).

i. **Disinterested Trustee.** Using a disinterested trustee is more protective than using the beneficiary or beneficiary's spouse as trustee. Specifically state that a beneficiary's spouse cannot serve as trustee. The disinterested trustee should build a record of carefully considering discretionary distribution requests to negate a claim that the disinterested trustee's discretionary distribution

power should be imputed to the beneficiary under an alter-ego or agency theory. *Cf. SEC v. Wyly*, 2014 WL 4792229 (S.D.N.Y. September 25, 2014) (this case is discussed in Item 17 of Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**).

j. **Forfeiture or Protective Trust Provision; "Safety Valve Provision."** A trust provision might terminate or suspend a beneficiary's interest and powers over a trust if the beneficiary is a defendant in a lawsuit or a party to a divorce proceeding. Alternatively, a trust protector acting in a non-fiduciary capacity may have the power to terminate or suspend a beneficiary's interest in the trust in such circumstances.

k. **Right to Information.** The trust could give a disinterested trustee the power to terminate or suspend a beneficiary's right to receive information about the trust, such as trust accountings or reports, if the trustee determines that receiving that information would not be in the beneficiary's best interest.

l. **Decanting.** Include a decanting provision in the trust that would allow the trustee to eliminate or modify beneficial interests. Such a provision in the trust agreement may be more expansive than a particular state's decanting statutory provisions, and may authorize decanting if a beneficiary should live in a state that has no statutory decanting povision.

m. **Governing Law.** Establish the trust in a jurisdiction that is more protective of trusts against divorce claims. Using the law of the place of administration (where the trustee resides) is typically recognized under conflict of laws principles. Authorize the trustee to change the trust situs and governing law.

3. Review of Pre-Existing Trusts; Other Drafting and Operational Considerations

One panelist uses the following checklist in reviewing pre-existing trusts regarding potential creditor or divorce attacks against the trust.

- Is the trust irrevocable?
- What is the situs and governing law of the trust? Does anyone have the power to change it?
- Is there a proper spendthrift clause?
- What is the status of the beneficiary: Sole beneficiary; primary beneficiary within a class; open class or closed class?
- Does the beneficiary have any mandatory rights?
- Is there a *Crummey* withdrawal power?
- Does anyone hold a power of appointment? What kind of power? Does someone have the power to grant a power?
- Can the trust be decanted? Must notice be given to the beneficiaries?
- Is there an ascertainable standard?
- What has been the pattern (if any) of distributions?
- Did letters accompany distributions? (If so, review those letters to see if they suggested or negated an intent to make similar future distributions.)

The panelist suggests the following drafting and operational considerations (in particular, in light of the *Levitan v. Rosen* case, discussed in Item 5.b below).

- Use a pot trust with multiple beneficiaries.
- Omit "primary beneficiary" language.
- Grant a non-general power of appointment to someone (a disinterested trust protector?) to easily move assets out of the trust.

- Include the ability to decant.
- Provide a "Trust Operation Memorandum" to guide a nonprofessional trustee to avoid an argument of a beneficiary having a de facto general power of appointment.
- Provide a sample "Letter of Distribution" to make clear there will be no pattern of distributions, and no weaving of the trust into the fabric of the marriage.

4. Spendthrift Exceptions

Spendthrift provisions are typically used to protect against the beneficiaries' creditors, but they provide little (or no) usefulness in divorce proceedings against claims for child or spousal support. A spendthrift provision restrains both voluntary and involuntary transfers of a beneficiary's interest in a trust, but statutes and courts have developed certain exceptions to spendthrift protection.

a. **Restatement.** Section 157 of the Restatement (Second) of Trusts includes an important exception regarding the enforceability of spendthrift provisions against creditor claims: "Although a trust is a spendthrift trust or a trust for support, the interest of the beneficiary can be reached in satisfaction of an enforceable claim against the beneficiary, (a) by the wife or child of the beneficiary for support, or by the wife for alimony …."

b. **State Statutes.** Many states have statutes providing limited exceptions against the enforceability of a spendthrift provision. Many states have exceptions for both spousal claims and child support claims, but some states allow an exception for only child support (but not spousal) claims.

c. **Common Law.** Some states have no statutory provisions but have developed case law regarding the enforceability of spendthrift provisions and applicable exceptions to that protection. The Delaware statute has no exception, on its face, for spousal or child support obligations, but a 1973 Delaware Supreme Court case (*Garretson v. Garretson*) held that the protection against creditor claims does not apply to a spouse seeking maintenance.

5. Massachusetts Experience

Massachusetts is known for being particularly protective of spouses in claims against trusts in divorce actions.

a. ***Pfannenstiehl v. Pfannenstiehl.*** The trial court in the *Pfannenstiehl* divorce case considered the husband's interest in a discretionary spendthrift trust created by his father in 2004 as a marital asset, and ordered the husband to pay about $1.4 million from the trust to his wife. The trust provided for distributions to the husband and the father's other descendants for their "comfortable support, health, maintenance, welfare and education." The husband had received substantial distributions in 2008-2010 prior to the divorce action (distributions continued to his siblings but not to the husband during the divorce proceedings). The judge viewed the husband's interest in the trust as a "vested interest" and as marital property in determining equitable distribution in divorce. The trust's spendthrift clause did not protect the beneficiary's trust interest in the divorce action; the court concluded that "settled trust law … holds that the mere statement of a spendthrift provision in a trust does not render distributions from a trust, such as this one, immune to inclusion in the marital estate." The Massachusetts appellate court's 2015 decision upheld the trial court in finding that the husband's beneficial interest was sufficiently similar to a property interest that it was includible in the marital estate. 37 N.E.3d 15 (Mass. 2015).

   When the trustees refused to distribute the $1.4 million amount to the husband and the husband could not and did not pay that amount to the wife, the trial court held the husband in contempt and put him in jail. An appellate court set aside the judgment of contempt, commenting that the husband had "at least ostensibly tried" to obtain funds from the trust and that he had not "willfully and intentionally violated a clear and unequivocal order."

   The Massachusetts Supreme Judicial Court reversed the trial court's prior finding that the trust interest was part of the marital estate. 55 N.E.3d 933 (Mass. 2016). The court reasoned that whether a trust is included in a divisible marital estate depends on whether the interest is a "fixed

and enforceable" property right, or "whether the party's interest is too remote or speculative" to be included. That determination turns "on the attributes" of the specific trust at issue and an evaluation of the facts and circumstances of each case. The court concluded that the husband's discretionary trust income and remainder interest was not part of the marital estate, taking into account various facts including: the trustees could distribute assets to the husband and 10 other beneficiaries in the trustees' "sole discretion" as they "may deem advisable from time to time" under an ascertainable standard; the trust had an open class of beneficiaries, unequal distributions could be made among the beneficiaries, trust distributions were not equal from year to year and from beneficiary to beneficiary. The court distinguished another case (*Comins v. Comins,* 33 Mass. App. Ct. 28 (1992)) in which a spouse was the sole beneficiary of the trust and held a testamentary power of appointment over the trust:

> Unlike the spouse in Comins, however, Curt is one of eleven living beneficiaries among an open class of beneficiaries. The trustees of the 2004 trust are required to take into account the trust's long-term needs and assets, unpredictability in the stocks that funded it (which the judge found at times in the past have provided no income or have incurred a loss), the changing needs of the eleven current beneficiaries, and the possibility of additional beneficiaries. Curt's present right to distributions from the 2004 trust is speculative, because the terms of the trust permit unequal distributions among an open class that already includes numerous beneficiaries, and because his right "to receive anything is subject to the condition precedent of the trustee having first exercised his discretion" in determining the needs of an unknown number of beneficiaries [citation omitted].
>
> …
>
> Considering the language of the 2004 trust, and the particular circumstances here, the ascertainable standard does not render Curt's future acquisition of assets from the trust sufficiently certain that they may be included in the marital estate …

The court did leave several issues open. First, the "trust may be considered an expectancy of future 'acquisition of capital assets and income' in determining how to divide the assets that are subject to division." Second, the trial court originally did not "use any future stream of [trust] income from distributions in assessing alimony" because the husband's interest in the trust was included in the division of property. Because the court determined that the trust interests "should not have been included in the divisible marital estate, it may be appropriate on remand for the judge and the parties to revisit whether alimony is now appropriate, and, if so, in what amount, on the basis of the factors the judge may deem relevant" pursuant to statutory authority.

b. ***Levitan v. Rosen.*** In a trust established by the wife's father, wife could withdraw 5% annually and other distributions could be made in the independent trustee's discretion. The wife was the primary beneficiary, and the trustee would have no liability for favoring the wife to the complete exclusion of the remaindermen. Following the wife's death any remaining assets would pass to her descendants. The trust contained a spendthrift provision.

The court held that the wife's entire interest in the trust was part of the marital estate because it was a fixed and determinable interest and more than a "mere expectancy." The court distinguished *Pfannenstiehl* because the wife was the sole beneficiary, her interest would not be diluted by future beneficiaries, and the settlor's intention was to provide only for her rather than for future generations. Even though the wife's interest in the trust was part of the marital estate, trust assets could not be assigned to the divorcing husband due to the spendthrift clause. *Levitan v. Rosen*,124 N.E.3d 148 (Mass. App. 2019).

6. Governing Law Issues

a. **Significance.** Choice of law issues may arise at two different stages – (i) in the original divorce proceeding in the place of the domicile of the married individuals, and (ii) in a subsequent proceeding to enforce a judgment from the divorce court against a trust in the place of the trust's administration. The applicable governing law can be very important in determining whether a beneficiary's interest in the trust is considered marital property to be divided between the spouses and in determining whether an award of trust assets can be enforced against the trust.

b. **Restatement (Second) of Conflict of Laws.**

(1) **Real Property.** For immovable property (real property), the law of the real property situs generally governs. Restatement (Second) of Conflicts of Law §§239 (will validity and effect), 279 (disposition under trusts).

(2) **Movable Property—Generally.** For movable property (everything else) the law of the decedent's domicile generally governs. *Id.* §263 (will validity and effect). For trusts that own personal property, the choice of law in the trust will govern disposition as long as a substantial relationship to the jurisdiction selected exists and the application of the law does not violate a strong public policy of the state with the most significant relationship to the trust.

(3) **Law Selected by Settlor.** As to the applicable spendthrift law that applies to a trust, Section 273 of the Restatement (Second) of Conflict of Laws (1971) provides that the governing instrument controls as long as sufficient contacts exists with that state. It provides that for an inter vivos trust the applicable law is the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered, and otherwise by the local law of the state to which the administration of the trust is most substantially related. Comment c to that section provides that "if the settlor has manifested an intention that the trust is to be administered in a particular state, such as by naming as trustee a trust company of the state, the applicable law is the local law of that state."

(4) **Strong Public Policy Exception.** Section 270(a) of the Conflict Restatement provides a different approach than merely using the settlor's choice of law. Interestingly, §270 is titled "Validity of Trust of Movables Created Inter Vivos." While this section deals with whether the *trust* is valid, it is often cited with respect to the validity of particular provisions in the trust, and says that the choice of law designated in the trust agreement does not necessarily control:

> An inter vivos trust of interests in movables is valid if valid,
>
> (a) under the local law of the state designated by the settlor to govern the validity of the trust, provided that the state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the state has its most significant relationship under the principles stated in § 6, or
>
> (b) if there is no such effective designation, under the local law of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in §6.

Comment b provides insight to the "strong public policy" clause:

> [The designated law] will not be applied if this would violate a strong public policy of the state with which as to the matter in issue the trust has its most significant relationship. Thus, where the settlor creates a revocable trust in a state other than that of his domicil, in order to avoid the application of the local law of his domicil giving his surviving spouse a forced share of his estate, it may be held that the local law of his domicil is applicable, even though he has designated as controlling the local law of the state in which the trust is created and administered.

(5) **Tension.** The tension between Sections 270 and 273 of the Conflicts Restatement often arises in conflict of law issues regarding trusts, and courts sometimes rely on one of those sections without even mentioning the other. *E.g.*, *In re Huber*, 493 B.R. 798 (Bank. W.D. Wash. 2013) (extensive discussion of §270 but failed to reference §273).

c. **Uniform Trust Code.** 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 32 jurisdictions that have enacted the UTC have enacted some form of §107(1). 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).

7. Grantor Trust Taxation Issues Following Divorce

a. **Repeal of §682.** The 2017 Tax Act provides that alimony payments will not be deductible and will not be income to the recipient. In addition, the 2017 Tax Act repealed §682 for divorces that occurred after 2018; 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 the discussion in Item7.c below about the ACTEC comments filed with the IRS on July 2, 2018 (available at **https://www.actec.org/resources/government-relations/**) suggesting the possibility of a contrary result).

The elimination of the alimony deduction and the repeal of §682 are permanent and do not sunset after 2025.

b. **Repeal of §682 Applies for Divorces After 2018, Even as to Pre-Existing Irrevocable Trusts.** The repeal of §682 applies to all divorces or legal separation agreements entered into after 2018, even for irrevocable trusts that were executed before any notice about the possible repeal of §682. This creates an extreme unfairness for grantors who created irrevocable grantor trusts with the understanding that the grantor would not have to pay income tax on the trust income following a divorce to the extent of any fiduciary accounting income that the donee-spouse is "entitled to receive." Tax law changes affecting irrevocable trusts are typically prospective only because of the unfairness that can result. *See Estate of Gerson v. Commissioner*, 507 F.3d 435 (6th Cir. 2007). ACTEC submitted a letter to Congressional leaders on July 5, 2018 (also available at **https://www.actec.org/resources/government-relations/**) recommending that legislation add, as a transitional rule to the repeal of §682, that the repeal should apply only to trusts that became irrevocable after December 22, 2017 (to the extent that income is not attributable to corpus added after that date).

c. **ACTEC Comments Regarding Applicability of Various Grantor Trust Provisions Following Divorce in Light of §682 Repeal.** Notice 2018-37 solicited comments in light of the repeal of §682 on whether further guidance is needed following a divorce or separation after 2018 regarding the application of §§672(e)(1)(A) (treating grantor as holding any power or interest of the grantor's spouse for purposes of the grantor trust rules), 674(d) (which includes the grantor's spouse as someone who is not an independent party for purposes of the independent party exception to §674)), and 677 (triggering grantor trust treatment if income can be distributed without the consent of an adverse party to the grantor or the grantor's spouse). For example, regulations might address whether a trust should continue to be a grantor trust after divorce based on powers or interests held by an ex-spouse in the trust. ACTEC's comments to the IRS on July 2, 2018 (noted above) state that the spousal unity rule appears not to apply following divorce or legal separation for purposes of §§674(c), 674(d), and 675(3) because of changes to the spousal unity rule in 1988 and because of §674(d) ACTEC recommends that the IRS clarify that position in regulations. Also, ACTEC recommends that the IRS clarify in regulations that Reg. §1.677(a)-1(b)(2), which states that §677 applies "solely during the period of the marriage" should continue to be applicable even after the adoption of the spousal unity rule, and the spousal unity rule should not apply for purposes of §677 following divorce or legal separation of the spouse from the grantor.

Guidance regarding these issues appears to be a low priority for the IRS. No guidance or other further IRS notice of any kind about this issue has been published following the submission of these ACTEC comments 2½ years ago.

d. **Planning Considerations for SLATs.** 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). Section 682 might not have even 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 for existing trusts include (i) if possible within state law and fiduciary limitations, consider decanting or trust modification to eliminate the ex-spouse's interest following the divorce, (ii) negotiate in the divorce for how income taxes will be paid on trust income, (iii) have the trust reimburse the grantor for income taxes attributable to the trust if the trust agreement or applicable law authorizes such reimbursement (but a pattern of reimbursement might trigger estate inclusion for the grantor), (iv) 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), and (v) terminate the trust or distribute trust assets to the ex-spouse or other beneficiaries (that will likely defeat the grantor's purpose for creating the trust but at least the grantor would not be taxable on future trust income).

Planning suggestions for drafting new SLATs in light of the repeal of §682 include (i) require the consent of an adverse party to distributions to the spouse following a divorce (which should prevent the application of §677 so the trust would no longer be a grantor trust if no other grantor trust triggers apply), (ii) eliminate or give some third party the ability to eliminate the grantor's spouse as a beneficiary following a divorce, and (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; however, consistently reimbursing the grantor for such income taxes may trigger estate inclusion for the grantor as an implied agreement of retained enjoyment under §2036(a)(1). 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*, ABA FAMILY LAW QUARTERLY (Summer 2018).

Items 8-11 are observations from the seminar at the Fall Meeting: Community Property Tips and Traps for Practitioners in Common Law States by Katherine C. Akinc, T. Randall Grove, Nancy G. Henderson, and M. Read Moore

8. What is Community Property?

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

b. **General Approach.** Under community property systems, all property of the spouses constitutes either "separate" or "community" property. The community property system derives from civil law, whereas "common law" property systems derive from English law, under which title is critical in determining ownership of property. The community property states in the U.S. and community property foreign jurisdictions are described in Item 8.o below.

c. **Separate Property.** A spouse's separate property includes (1) property owned or claimed by the spouse prior to marriage, (2) property acquired during marriage by gift or inheritance, and (3) in some

states, the recovery for personal injuries sustained during marriage except for recovery for loss of earning capacity. If separate property is sold or exchanged, the resulting proceeds are also separate property, but only if they can be traced to the original separate property.

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

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

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

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

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

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

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

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

amounts of funds expended. (However, an offset to the reimbursement right may exist if the community estate benefited from use of the separate property asset.)

Similarly, if one spouse devotes time, talent, and labor to the enhancement of that spouse's separate property (such as the spouse's separate property business) and the community is not adequately compensated, consequences may result. In some states, such as Texas, the community might have a claim for reimbursement. In other states, such as Washington, a lien arises in favor of the community against the enhanced separate property. In some states, the community may acquire an interest in the enhanced business. Accordingly, providing "adequate compensation" is important, and what is "adequate" is in the eye of the beholder—the court making that determination.

j. **Transmutation; Partition.** In most community property states, spouses may agree to treat property as community property that would otherwise be separate property by executing a transmutation agreement. Alternatively, the spouses may agree to divide community property into the separate property of the spouses by a partition agreement.

k. **Beneficial Interests in Trusts.** Characterization of interests in trusts can be tricky. Generally, third-party trusts are created by a gift from someone, and when the trust assets are distributed, the distributions are part of that original gift and hence are separate property. States that treat income from separate property as community add another layer of complexity to this characterization. Texas, for example, holds that interests in trusts are gifts and trust assets are separate property when distributed. But if trust assets are improperly retained, contrary to the terms of the trust agreement, income from that property is community property in Texas, and that community property gets commingled with other trust property.

l. **Life Insurance.** The general inception of title rule applies to the ownership of a life insurance policy. If the policy is acquired with separate property, but subsequent premium payments are made with community property, a community claim for reimbursement may arise if the death proceeds do not benefit the community. Very importantly, if a community property policy is paid to someone other than the insured's surviving spouse, the surviving spouse is treated as making a gift of his or her one-half community property interest in the policy.

m. **Non-Participant Spouse's Interest in IRA.** If an IRA is community property and if the non-participant spouse dies first, can the non-particpant spouse leave his or her community one-half interest to someone other than the participant-spouse? The Supreme Court decided in *Boggs v. Boggs* that if the non-participant spouse predeceases, his or her community property interest in a qualified retirement plan is non-assignable, and the plan must remain for the benefit of the participant-spouse. That does not apply to IRAs, but many IRA custodians want a signoff from both spouses for dispositions of IRAs.

n. **Fraud on Community or Fraud on Spouse.** If one spouse makes a gift of community property to a third party without consent, the other spouse may claim rights under the "fraud on the community" (sometimes called the "fraud on the spouse") doctrine. Whether relief is granted depends on (i) the value of the gift compared to the entire community estate, (ii) whether the other spouse can be made whole out of the remaining community property assets, and (iii) the relationship of the donee (for example, a gift to an illicit paramour is more likely to be found a fraud on the community than a gift to a child of one or both of the spouses).

o. **Community Property States and Foreign Jurisdictions.** Historically, there have been eight community property states – Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. The community property systems in these states have generally evolved from Spanish law (although the Louisiana system derives from French law). In addition, Wisconsin has adopted a Uniform Marital Property Act that does not have the same Spanish law background but is a community property system. Rev. Rul. 87-13 recognizes Wisconsin marital property as the equivalent of community property for income tax purposes.

Alaska has adopted the Uniform Marital Property Act on an elective basis (i.e., spouses can opt-in to the community property system). The Alaska Community Property Act provides that spouses who are domiciled in Alaska may enter into a community property agreement to have some or all of their

property treated as community property. If one or both spouses is not domiciled in Alaska, the community property election can be made by transferring property to a community property trust. The IRS has not indicated whether it will respect the community property character of property under the Alaska opt-in system for federal tax purposes. (Oklahoma and Oregon had opt-in community property systems briefly, but they were quickly repealed.)

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

p. **Community Property Trust (Alaska, Kentucky, South Dakota, and Tennessee).** Alaska, Kentucky (effective July 15, 2020), South Dakota, and Tennessee allow spouses to establish a community property trust (called a special spousal trust in South Dakota), and if the trust satisfies the requirements of the legislation (for example, both spouses must sign the trust agreement), property transferred to the trust becomes community property under the relevant state law. Most states require a trustee to be a resident of the state, and the trustee must have certain minimum powers. In Tennessee, when property is distributed from the community property trust, it is no longer community property. Nonresidents of those states may generally create a community property trust pursuant to the laws of one of those states; the community property characterization will likely be recognized in other states, because choice of law provisions are generally respected unless they contradict a strong public policy of the domicile state. Conjuring up a strong public policy against having property owned equally by the spouses is difficult. The community property characterization will probably also be recognized under §1014(b)(6) because it refers to the law of "any state" (rather than just referring to the law of the state of domicile). The IRS has not confirmed that result; IRS Publication No. 555, "Community Property" (released March 2020) states that the Publication does not address the federal taxation of "income or property subject to the 'community property' election under Alaska, Tennessee, and South Dakota state laws."

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

a. **Property Rights.**

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

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

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

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

(5) **Rights to Make Gifts.** Some community property states prohibit a spouse from making gifts of community property assets. Other states allow a spouse to give property over which he or she has sole management authority unless the gift would be a "fraud" on the other spouse's community property rights (see Item 8.n above).

b. **Division on Divorce.** In a divorce, the common starting point is that community property is divided 50-50 between the spouses, and each spouse keeps his or her separate property. Some states (such as California) mandate that each spouse keeps his or her separate property and one-half of community property, but other states (such as Texas and Washington) allow a division of the community property in accordance with an equitable "just and right" division power of the court.

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

d. **Tax Effects.**

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

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

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

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

10. General Impact on Marital Property of Migrating Between Community and Noncommunity Law States

a. **Consider Client's Intent Whether to Retain or Change Character of Property.** Non-tax issues include the right to share in benefits of the property, control of assets, the ability of a spouse to make gratuitous transfers, the division upon termination of the marriage, and the effect of creditors' claims against assets.

Tax issues include the double adjustment of basis upon the death of the first spouse under §1014(b)(6) and the equalization of the estate for optimal utilization of the estate tax exclusion (though this is not as important now that we have portability of the estate exclusion amount).

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

The law of the state in which a married couple is *domiciled* at the time real or personal property is *acquired* determines the *character* of that property. The character of community property or common law property generally does not change upon the couple's move to another state. For example, when spouses move from a community property state to a common law property state, property acquired with community property funds and traceable to those funds continues to be community property, despite the fact that the couple then lives in a common law state. Restatement (Second) of Conflicts of Laws §259. In that circumstance, a sale of the original asset does not change the character of the

proceeds of such sale. *Id.* Various court cases have recognized this principle particularly with respect to personal property that is moved from a community property state to a common law state. (An exception to this general rule is the quasi-community property doctrine recognized in some community property states, under which the separate property of a spouse is treated as "quasi-community property" at the divorce and [in some states] at the death of a spouse.) When a couple domiciled in a common law state buys property in a community property state or vice versa, the character of the property is determined by the character of funds used to acquire it.

The IRS accepted that general analysis in Revenue Ruling 72-443 in determining state law property rights of a couple that moved from a community property jurisdiction (Norway) to a noncommunity property state in the U.S. and bought property in that state with funds brought from the community property jurisdiction.

> If married persons change their domicile from one jurisdiction to another, vested property rights are not affected thereby. The interest of the spouses in movable property is determined by the law of the domicile of the parties when the movables are acquired. Thus, movable property held by the spouses in community continues to be so characterized when they move into a jurisdiction whose laws do not establish community interests.…
>
> If married persons change their domicile, bringing with them funds in which each has an equal, vested interest, the laws of the new domicile will recognize this ownership.…
>
> The state in which the real property in question is located follows the general rules. It recognizes the vested rights of the spouse in the funds used to purchase the property and that those rights continue in the property purchased with the funds. It is immaterial under its laws that the funds were acquired under the community property laws of a foreign country rather than under the laws of a community property state in the United States.

Rev. Rul. 72-443 concluded that property owned by a Norwegian decedent in a noncommunity property state is owned equally by the decedent and his widow because they were subject to the default Norwegian marital property regime equivalent of community property.

Those are only general rules, however. For real property, the general doctrine of *lex situs* applies. Courts in common law property states usually refuse to apply community property principles in deciding issues related to the ownership of real property in the common law state. The community character of funds used to purchase real property in common law property states is recognized, but the courts often find that the spouses own such property as tenants in common in the common law property state rather than as community property. In contrast, courts in community property states have occasionally held that real property located in a common law property state is community property despite the *lex situs* principle. *See Tomaier v. Tomaier,* 146 P.2d 905 (Calif. 1944).

c. **Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA").** Sixteen states have enacted the 1971 Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA") (Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Minnesota, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming). UDCPRDA generally provides that imported property that was originally community property remains community property for purposes of testamentary dispositions—meaning that a deceased spouse can dispose of one-half of such property. Any property that is held by a married couple as tenants by the entirety or by another form of joint ownership with right of survivorship is presumed not to be community property, even if the community property state where the property was acquired treats the property as community property with rights of survivorship. Under UDCPRDA, (1) the personal representative has no fiduciary duty to discover whether property is community property, and (2) the surviving spouse has no elective share, dower, or curtesy rights in property subject to the act.

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

d. **Effect for Divorce Purposes.**

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

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

e. **Effect for Death Purposes.**

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

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

f. **Joint Revocable Trusts.** A good way to maintain the community property character of property acquired before moving to a non-community property state is to segregate the community property in a separate joint revocable trust. The trust should recite that the property is community property and provide that the community property character is retained while the assets remain in the trust. The spouses could revoke, alter, or amend the trust

Upon the death of the first spouse, 50% of the trust is included in the gross estate of the decedent. Rev. Rul. 66-283. Community property contributed to a joint revocable trust will be recognized as community for tax purposes (including the ability to take advantage of the "double basis step-up" under §1014(b)(6)) as long as it is still recognized as community property under state law. Rev. Rul. 72-443.

Contributing property to a spouse's own revocable trust may not be sufficient to change the character of the property. For example, in *Katz v. United States*, 382 F.2d 723 (9th Cir. 1967), the contribution of community property from husband and wife to husband's revocable trust did not change the property to the separate property of the husband because the community property presumption was not overcome.

g. **Segregate Assets.** If a joint revocable trust is not used to segregate assets, the spouses should at least take steps to segregate their community property and keep records tracing the character of the property.

11. Planning Strategies for Migrating Clients

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

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

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

d. **Avoid Commingling.** Establish separate accounts for community property and separate property, or use revocable trusts to hold separate and community property. Avoid commingling separate and community property assets in order to avoid tracing complexities. In states in which income from separate property is community property (see Item 8.e above), remove income (typically, interest and dividends) from the account as it is received.

e. **Request Marital Agreements.** Marital property agreements are more common in community property states than in common law states.

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

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

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

h. **Be Careful Before Acquiring Title as Tenants by the Entirety or Joint Tenancy or Using One Spouse's Separate Property to Acquire Property in Joint Names.** Couples moving from community property to common law property states should generally avoid taking title to assets with community property proceeds as tenants by the entireties or as joint tenants with rights of survivorship. Those designations are generally inconsistent with community property ownership. Conversely, using one spouse's separate property to acquire property in the names of both spouses may presumptively result in a gift of a one-half interest to the other spouse.

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

Items 12-19 are observations from the seminar at the Fall Meeting: Managing Your Law Practice in the New Normal and Beyond by Lora L. Brown, Kim Kamin, Bernard A. Krooks, Jill L. Miller, and Margaret Van Houten

12. Treasure Trove of Resources

The materials include a treasure trove of resources as appendices for an estate planning law practice:

A. Nondisclosure Agreement and Agreement of Confidentiality

B. Sample Escrow Instructions for Estate Planning Documents

C. Disaster Recovery Contact Information

D. The Super-Simple-This-Week Succession Plan

E. Four Ways to Decompress Now That Your Commute is Gone

F. Year in Review (for staff review of the year)

G. Client Screening Guide

H. Sample Engagement Letter with Retainer – Individual (Hourly)

I. Sample Engagement Letter with Retainer – Couples (Fixed Fee)

J. Sample Exit Letter

K. When Your Estate Planning Documents Should Be Updated

L. Requested Content for Estate Planning Documents (including changes in personal or financial circumstances that make a review desirable)

M. Client Questionnaire

N. Client Values Survey

O. Drafting Checklist for Basic Estate Planning Documents (including checklists for power of attorney for health care, power of attorney for property, will, revocable living trust, and irrevocable trust)

P. Assignment of Tangible Personal Property

Q. Sample Living Trust Funding Memo

R. Directions to My Trustees and/or Agent under Power of Attorney

S. Sample Letter of Wishes for Distribution of your Personal Property

T. Sample Letter of Wishes to Trustees: Descendants' Trusts

U. Sample Letter of Wishes to Trustees of Revocable Trusts

V. Sample Letter of Wishes for Incapacity and End of Life Guidance

W. List of Important Documents to Store

X. Sample Cover Letter for Executed Documents

Y. Analysis of Formal Opinion 477R

Z. Sample Office Policies and Procedures

13. Business and Staff Management

a. **Client Interactions.** One panelist's website says she is not in the office and to communicate by email for quicker response. The website informs prospective clients not to give details about an issue involving another party until a conflicts check can be completed.

Let clients know realistically when a response will be made. Clients do not expect immediate response; we just think they do.

b. **Storing and Safekeeping of Documents.** If the attorney stores signed documents, have the client sign an escrow agreement providing authority for disclosing and releasing the documents. Some of the panelists typically store estate planning documents for their clients but some do not (a concern is

that when the attorney retires, dealing with the retained documents can be a very time-consuming chore).

c. **Billing and Payment Issues.** Online payments can be very convenient for clients (which may result in more timely payment), and may automatically be recorded into the attorney's accounting system. Options for consideration include LawPay, Costco, and Gravity Legal.

d. **Disaster Planning.** Have a written emergency plan with key information such as building contacts (building management, security and sub-tenants or office neighbors), vendors of essential services (telephone, internet, technology support, firm management software, computer remote access, computer backup, web host, and offsite storage facility), financial services (bank vault, banks, payroll processing, 401k provider, pension plan, accountant), insurance (broker, workers compensation insurance, business owners insurance, professional liability, cyber security), and employees.

14. Work/Life Balance

Take care of yourself first (like putting the oxygen mask on yourself first).

Several panelists start the day with meditation (thinking about things that are going well and setting priorities for the day). One panelist starts the day with an attitude exercise – 1) What is a thing I am thankful for? 2) Who is a person I am thankful for? 3) What is something I am thankful for about myself? "I'm still a complainer, but the attitude exercise helps."

15. Client Development and Management

a. **Client Development.** One panelist sends 400 personalized holiday cards, thanking recipients for the relationship with them. "It takes a lot of time to write 400 cards, but it always pays off."

"It's easier to develop more work for your current, great clients."

Marketing and educational pieces can be helpful for clients, prospects, and centers of influence.

b. **Screening Potential Clients.** "Trust your 'gut' if red flags arise!"

c. **Engagement Letters.** Consider securing a retainer. Include proper conflict language for couples, and clearly state rates and out-of-pocket charges (including late fees).

16. Drafting and Managing Client Instruments

a. **Drafting Challenges in Pandemic.** Drafting may become less paper-oriented in a remote working environment, where high-speed and high-volume printers are not available. Coordinating drafting with paralegals or other attorneys is much more difficult (without the ability to simply drop handwritten edits in the next-door office).

b. **Client Decision Intake.** One of the exhibits is a memo that can be sent to a client before a meeting describing various issues for decisions about wills, revocable trusts, and property and health care powers of attorney.

c. **Drafting Assembly.** Two major drafting systems are template forms or document assembly systems. One panelist uses a template system but her client management software auto-populates names into the forms.

d. **Drafting Processes.** Using checklists can help avoid human error. The exhibits include detailed checklists for powers of attorney for health care, powers of attorney for property, wills, revocable living trusts, and irrevocable trusts. For editing and reviewing customized clauses, consider reading the clauses out loud.

e. **Drafting Conventions.**

(1) **Name of Trust.** Use a name for the trust that is descriptive, for example "Charitable Lead Annuity Trust," "GST-Exempt Trust," "Dynasty Trust," "Lifetime Family Trust," or "2020 Family Trust" (for a client with trusts created in multiple years).

(2) **Labeling of Trust Sections.** Labeling trust articles and paragraphs assists the reader in understanding and navigating around the trust, and works even better when a table of contents is also included.

(3) **Ordering of Provisions.** Place the most important information toward the front of the document, with boilerplate in the back.

(4) **Personalization.** Use all caps or bold font for individual names (to make the names easier to spot and review). Using a defined term for names can help streamline the document (for example, JAMES ALEXANDER MACKENZIE FRASER ("JAMIE")).

(5) **Identify Relationships.** Identifying the relationships of people named in the document (e.g., "my friend," "my partner," "my sibling") can be helpful to other people using the document.

(6) **Gender Issues.** Clients take offense to using only male pronouns. "It might be most prudent to avoid utilizing gendered pronouns altogether now that 'they/their/them' has become acceptable to use in the singular."

(7) **Formulas.** Test formulas with various real number scenarios to make sure they work properly.

(8) **Privacy.** Family member identification may be unnecessary but if family member identification is included ("my children, John Doe and Jane Doe"), do not include birthdates or social security numbers (wills eventually become public documents).

(9) **Testamentary Powers of Appointment.** "[T]estamentary powers of appointment preferably should not be required to be exercised in a will, and especially not a will that must be probated." Specify that testamentary powers of appointment can be exercised in a will or other instrument that is delivered to the trustee during the decedent's life or at death expressing that the instrument becomes effective at the powerholder's death.

f. **Implementation of Estate Plan.** Attorneys who create revocable trusts should help clients fund those trusts. The exhibits include a Living Trust Funding Memo. The ACTEC website contains a checklist for Transfer of Property to Revocable Trust at **www.actec.org/assets/1/6/Checklist_for_Transfer_of_Property_to_Revocable_Trust.pdf**.

g. **"Death Book."** Clients should have a "death book" or comprehensive collection of relevant information in the case of an emergency/death. A pre-mortem checklist is posted on the ACTEC website at **https://www.actec.org/assets/1/6/Pre_Mortem_Checklist.pdf**.

h. **Letters of Wishes.** The exhibits include various examples of letters of wishes to provide additional guidance to trustees and beneficiaries.

17. Ethical Rules Impacted by Technology

a. **Technology Issues.** Recent technology issues that may raise ethical concerns include cyber threats to confidential client information – phishing and ransomware. Other recent technology issues for estate planners include planning for digital property, legislative developments regarding electronic wills, and artificial intelligence issues.

b. **Model Rule 1.1, Competence.** "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." A new addition to comment 8 provides that lawyers should "keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology…."

c. **Model Rule 1.6(c), Confidentiality of Information.** "A lawyer shall make reasonable efforts to prevent the inadvertent or unknown unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client."

Comment 18 states that Rule 1.6(c) requires lawyers to act competently to safeguard information. Furthermore, comment 18 provides that a client may require the lawyer to implement special

security measures not required by Rule 1.6(c) or may give informed consent to forego security measures that would otherwise be required.

Comment 18 clarifies that "reasonable efforts" factors include sensitivity of the information, likelihood of disclosure if additional safeguards are not employed, cost of employing additional safeguards, difficulty of implementing the safeguards, and the extent to which safeguards adversely affect the lawyer's ability to represent clients (for example, because of their difficulty of use).

d. **ABA Opinions.** ABA Formal Opinion 11-459 states that a lawyer communicating with the client by email "ordinarily must warn the client about the risk of sending or receiving electronic communications … where there is a significant risk that a third party may gain access."

ABA Formal Opinion 477R addresses the requirement that a lawyer use reasonable efforts to prevent inadvertent or unauthorized access. It states that using unencrypted routine email generally constitutes an acceptable method of communication, but is not always reasonable. It includes guidelines about reasonable efforts that should be taken with respect to technology and information security issues.

ABA Formal Opinion 480 addresses confidentiality obligations for lawyer blogging and other public commentary.

ABA Formal Opinion 483 discusses lawyers' obligations after an electronic data breach or cyberattack.

The general approach of the ABA opinions is that security should be balanced with practicality.

e. **Engagement Letters.** ABA Formal Opinions 11-459 and 477R both recommend informing clients about certain risks involved in electronic communications. Lawyers should consider including such a provision in engagement letters.

18. Technology Security

a. **Home Security.** Use a virtual private network (VPN) on all devices.

Install a security and antivirus system for the home network. Systems used by the panelists include Bitdefender, CrowdStrike Falcon, and Barracuda.

Keep the home router updated and secure. Consider updating it about every five years.

b. **Security Policy.** Law firms should adopt a detailed security policy. (If a security breach occurs, having a policy in place helps show that the firm acted reasonably.) The exhibits include one firm's detailed Technology Security Policy.

c. **Portable Storage Devices (Flash Drives).** Flash drives should be encrypted (because they may easily be lost).

d. **Password Manager.** Use a password manager. Some of the recommended password managers are: (1) Keeper Password Manager and Digital Vault; (2) Last Pass; (3) Dashlane; (4) Bitwarden Premium; and (5) 1 Password.

e. **Ransomware.** Merely backing up information to a hard disk to avoid ransomware hackers does not work if the hard disk is left plugged into the computer. Make sure that hackers cannot get to the backup.

f. **Electronic Signatures.** Some of the top-rated software systems for electronic signatures are: ZorroSign eSignature, DocuSign, Formstack Sign Easy, eSign Genie, and eversign.

19. Remote Working in Another State

Working remotely in another state raises two issues: (1) Income tax (where is the income sourced?); and (2) Unauthorized practice of law if the attorney is not licensed to practice in the state where the attorney is working remotely. (One firm is requiring all of its attorneys working remotely in other states to return to the home state by December 31.)

State laws vary regarding the unauthorized practice of law issue. In Florida, there is no unauthorized practice of law if the attorney is only giving advice about the original state where the attorney is licensed. That is not the case in all states. Some states are in the process of issuing ethical opinions about this unauthorized practice of law issue.

Items 20-26 are observations from the seminar at the Fall Meeting: Art Law by Margaret J. Hoag (Senior Vice President, Deputy General Counsel Americas, Christie's), Nicholas M. O'Donnell (Partner, Sullivan & Worcester), and Ramsay H. Slugg. Much of the summary in Items 18-20 below is from the outstanding outline in the course materials by Ramsay H. Slugg

20. Unique Challenges of Planning With Art

a. **Emotional Aspect of Art.** Art and other collectibles are assets of passion, making them difficult assets to incorporate into the overall estate plan. "Art collecting started off as a hobby and now it's a disease." Art collectors love to collect and do not like to sell. When a collector loves a piece of art, thinking about what happens to the art when the collector is gone is difficult.

b. **Cash Flow.** Most estate planning techniques work better with cash flow (for example, to pay principal and interest on a note for a sale to a grantor trust). Clients remind their planners that art collecting has a lot of cash flow-but it's all flowing in the wrong direction.

c. **Substantive Law.** Art involves a wide variety of substantive law, including property law, contract law, tax law (income, gift, estate, sales tax), etc. in addition to specific laws regarding art.

d. **Ultimate Disposition Alternatives.** Art collectors focus on the passion of collecting, not disposition of the art. When they do consider disposition, they can be overwhelmed with choices, but there are ultimately only three general options—sell to third parties, give (or sell) to family (or other non-charity), or donate to charity, and each of those can happen during life or at death, resulting in six alternatives. The collector eventually must address the "four W's" for each piece of art—What goes Where, to Whom, and When.

e. **Advisors Unaware of Scope of Collection.** Advisors are often unaware of the extent or value of their clients' collections and therefore merely use traditional tangible personal property disposition clauses in estate planning instruments.

f. **Collection Management.** Unique management practices are needed for art. Planners may need to devote special attention to assisting their clients with appropriate collection management practices rather than or in addition to traditional transfer planning.

21. Collection Management Practices

a. **Professional Staff.** Some collectors have professional staff to assist with management of the collection, but many do not and will need guidance.

b. **Risk Management.** Risk management is about having safeguards to prevent damage to the collection. Preventing damage is better than filing an insurance claim after damage occurs.

   Homeowners' insurance (possibly with valuable items coverage for separately scheduled assets) may be sufficient for some art owners but it is not sufficient for a sizable collection. Some really big collectors self-insure, but that is very scary. Use a high-end insurance broker with expertise in art risk management including best practices concerning security, fire, and smoke damage protection. Art insurance claims include accidental damage (representing the highest volume of claims), theft, fire, storm or water damage, and "lost/mysterious disappearance."

   Accidental damage is most likely to occur when art is moved. Use a specialist to properly pack, handle, and transport valuable collectibles.

   Most stolen art is never recovered; the FBI indicates that only about 5% of stolen art is recovered. Accordingly, the best course of action, as with all risk management, is preventing theft in the first place.

c. **Inventory/Cataloguing.** Maintaining good inventories is very important for collectors (and is an element of proper risk management). Good inventories help preserve the collector's knowledge about the collection. Inventories can range from 3x5 cards to museum registrars. Some collectors may have full-time staff to maintain inventories.

   Merely retaining bills of sale and catalogs of sales where art is purchased may constitute an inventory of sorts.

   An art inventory should, at a minimum, include a description of each piece (including name, if any), artist name, acquisition date, where and from whom it was purchased, purchase price, condition (including any known repairs), and its physical location. Note any exhibits or tours in which the piece has been displayed. The inventory could be expanded to include research about specific pieces and any externally maintained registries that include the work and other works by the artist. Photographs could be included, and an identification number could be assigned to each piece. This information helps to identify and authenticate each piece and greatly assists if a theft occurs or any questions of provenance arise.

d. **Valuation Considerations.** The three ultimate disposition options (sales, gifts, or charitable donations), each either during life or at death, create six options. Five of those six require a qualified appraisal (an appraisal is not required for a sale during life).

   Revenue Procedure 66-49 provides guidelines for an appraisal to support a federal income tax charitable deduction for donations of tangible personal property, including art. These requirements have been modified, most notably by the Tax Reform Act of 1984 (adding substantiation requirements and further defining the term "qualified appraisal," see Reg. §1.170A-13(c)(3)(iv)(B)) and the Pension Protection Act of 2006 (adding heightened requirements for qualified appraisers including subjecting the appraiser to civil penalties under certain circumstances, see Notice 2006-96, §3.04(2)). IRS Publication 561, *Determining the Value of Donated Property*, provides further guidance.

   The IRS Art Advisory Panel was created in 1968 to assist the IRS when reviewing art with an appraised value of $50,000 or more. It consists of 25 art experts and meets several times a year to review appraisals submitted to them. While the panel's recommendations are advisory, the IRS typically accepts their valuation recommendations. Collectors can obtain an advance ruling from the IRS, assisted by the Art Advisory Panel, for income tax purposes. Rev. Proc. 96-15.

   Having updated appraisals is helpful for various purposes. Insurance coverage requires an initial appraisal and periodic updates. Appraisals are also invaluable in assisting with decisions about the collection.

e. **Provenance/Authenticity/Good Title.** At one time, "possession was 9/10s of the law" regarding art ownership, but Nazi looted art started showing up at auctions, and being able to establish ownership of art has become more important. The "provenance" of a piece of art is a written compilation of the chain of possession, generally including exhibition history and bibliography. The field of provenance goes beyond recovering stolen art to concerns about authenticity and forgery, the chain of title, and competing claims about a work of art. Many forms of tangible personal property, including art, do not have established ownership documentation systems (such as certificates of title for automobiles). Registries may provide some evidence of ownership for certain art pieces. Collectors mostly have to build their own ownership files including certificates of authenticity, bills of sale, import and export documents, correspondence, insurance records, and perhaps affidavits from prior owners.

f. **Liquidity.** Art can become a very important part of a person's overall portfolio, and the art collection is highly illiquid, with cash flow "flowing in the wrong direction."

g. **Sales and Use Tax.** Sales and use tax planning has become critically important. The auction houses are very familiar with the rules regarding sales and use taxes (which can be quite significant). People have gone to jail for violating sales tax rules.

h. **State Income and Estate Taxes.** Many clients reside or conduct activities in multiple states, and state income and estate taxes may be significant. State income taxes are particularly important with respect to sales of art during life.

22. Planning Options for Disposition of Art

a. **Disposition Alternatives.** When a client expresses frustration over decisions about what to do with art as part of the overall estate plan, the planner should reiterate the three basic options (sell, give to family, or donate to charity, with each of these beginning either during life or at death, as described in Item 20.d above). These are not mutually exclusive, and a client may choose different options for different pieces in the collection.

b. **Big Question—Does the Family Want the Art?** The client believes the family will, of course, want to keep the wonderful collection, but the next generation often does not share that same passion for the art. Do not waste fancy planning on something the children and grandchildren will just end up selling as quickly as possible. While knowing the family's desires is very important for the planning process, the discussion of this issue with the family can be delicate.

The family's wishes will impact planning decisions. Certain wealth-transfer techniques are designed to maintain art ownership in the family, but if the family just cares about the wealth represented by the art, other simpler solutions may be appropriate.

c. **Sales.** If the client decides to sell, selling the art at death may result in significant tax savings. A sale during life will incur a 28% capital gains tax, an additional 3.8% net investment income tax, and possible state income tax, for close to a 50% income tax rate. An additional 40% estate tax will apply to what is left, resulting in a combined tax rate over 65%. The 2017 Tax Act removed like-kind exchanges for art (and other tangible personal property). "Art is not only very expensive to buy but also expensive to sell."

Waiting until the collector's death to sell the art not only avoids income tax on the capital gains (due to the basis step-up at death) but also allows the collector to keep the art for enjoyment.

d. **Transfer Planning for Transfers to Family.**

(1) **Sooner Rather Than Later.** Giving (or selling to a grantor trust) to family earlier rather than later has the advantage of shifting future appreciation from the estate, and takes advantage of the "lower gift tax than estate tax" phenomenon. The disadvantage of the lifetime transfer is that no basis step-up at death is available.

(2) **Valuation Discounting.** The IRS has historically taken the position that valuation discounts are not available for art, even if transferred as a fractional gift or through an FLP/LLC structure. The few cases addressing fractional discounts for art have generally resulted in low discounts. *Scull v. Commissioner*, T.C. Memo. 1994-211 (5% discount); *Stone Trust Agreement v. United States*, 103 AFTR 2d 2009-1379 (9th Cir. 2009) (5% discount for estate that owned an undivided 50% interest in 19 paintings). More recently, the Fifth Circuit Court of Appeals reversed a Tax Court decision allowing only a 10% undivided interest discount, resulting in approximate 65% discounts for fractional interests in 64 pieces of artwork owned by the estate (but in that case, the IRS presented no evidence to support its position or expert testimony as to an appropriate discount). *Estate of Elkins v. Commissioner*, 767 F.3d 443 (5th Cir. 2014), *rev'g* 140 T.C. 86 (2013).

(3) **FLP/LLC Structure.** If the collector wishes to keep a collection largely intact, the collection could be contributed to an FLP or LLC, and transfers could be made by transferring interests in the FLP or LLC to family members. Management of the collection can be provided by the entity. Probate transfers at death will be simplified because there will be no need to retitle, change insurance coverage, etc.; the collection will continue to be owned by the entity.

(4) **Trust Structures Generally.** Transfers may be made to trusts, for the traditional advantages of using trusts. Special considerations apply for trusts owning art. (i) The trust will need additional funds to pay expenses of maintaining the collection. (ii) The owner generally must give up

possession of the art, or else §2036 will cause the art to be included in the collector's gross estate for estate tax purposes (although the owner may be able to lease the art, as discussed in Items 22.d.(6)-(7) below), and issues arise as to where the trust will ultimately keep the art. (iii) A trust owning art may be more expensive to administer than a trust owning financial assets.; the trustee will need to have expertise in maintaining the collection or other experts will need to be employed.

Special trust drafting issues should be considered. Ramsay Slugg summarizes:

> Normal trustee powers and duties may need to be altered, especially as they relate to any requirement to invest prudently, diversify investments, and make trust property productive. Trustees will need the right to delegate responsibilities and hire appropriate experts.[33]
>
> [33] For more on trust drafting considerations, see the excellent discussion in Michael Duffy, *Whom Do You Trust with Your Picasso? Planning Considerations for Trusts That Hold Title to Works of Art*, PROBATE AND PROPERTY, September/October 2013.

(5) **Tangible Personal Property GRIT.** A "grantor retained income trust" funded with tangible personal property for family members must value the grantor's retained interest at its actual fair market value (i.e., the fair rental value of the art or other collectible). I.R.C. §2702(c)(4); Reg. §25.2702-2(c). Little weight is accorded appraisals that are not based on actual sales or rentals that are comparable both as to the nature and character of the property and the duration of the term interest. Reg. §25.2702-2(c)(3). An active marketplace for rentals of museum quality pieces does not exist, so the evidentiary requirements for a tangible personal property GRIT may be difficult to satisfy for valuable art (in which event the retained interest may be valued at zero under §2702, resulting in a large unexpected gift tax).

(6) **Section 2036 Issues.** If the client wants to make a gift (but not really) and wants to continue to enjoy the art, a classic approach is to give or sell the art to a grantor trust, but for the client to lease the art for fair market rental value. The overall result can feel like a win-win to the donor. The donor gets to continue enjoying the art and get even more assets out of the gross estate by paying the rental payments. "The donor signs a foot worth of paper but still looks at the Monet on the same hook on the wall."

Section 2036(a)(1) provides that the gross estate includes the value of all property to the extent the decedent: (i) has made a transfer other than a bona fide sale for a full and adequate consideration; (ii) under which he [using the male-specific pronouns used in the statute] has "retained" the possession or enjoyment of, or the right to the income from the property; (iii) for his life or for any period not ascertainable without reference to his death (example: income quarterly for life but income in the quarter of his death will not be paid) or for any period which does not in fact end before his death (example: retain income for five years and donor dies within that five year period).

Section 2036 applies if the donor retains the explicit right to use the donated asset, but also applies if there is an implied understanding that the settlor will be allowed to use or receive income from the transferred property. Reg. § 20.2036-1(c)(1).

If the donor retains use of the transferred property under a lease agreement that provides for fair rent, it is not clear whether §2036 applies. *See generally* Dodge, *Transfers with Retained Interests and Powers*, 50-5th T.M. at 162-163 (2002); Stephens, Maxfield, Lind & Calfee, FEDERAL ESTATE AND GIFT TAXATION, ¶4.08[6][c] (2001). Applying the statute is problematic, because the statute only applies to transfers for less than full and adequate consideration, and the donor would be paying full consideration for the right to use the property. It is ironic that paying rental payments even further depletes the donor's estate. However, the trend of the cases is not to apply §2036 where adequate rental is paid for the use of the property. *E.g.*, *Estate of Barlow v. Commissioner*, 55 T.C. 666 (1971) (no inclusion under §2036 even though decedent stopped paying rent after two years because of medical problems); *Estate of Giselman v. Commissioner*, T.C. Memo 1988-391. The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the

end of the QPRT term under §2036. *E.g.*, Ltr. Rul. 199931028. However, the IRS does not concede that renting property for a fair rental value always avoids application of Section 2036. *See* Tech. Adv. Memo. 9146002 (*Barlow* distinguished). Most of the cases that have ruled in favor of the IRS have involved situations where the rental that was paid was not adequate. *E.g.*, *Estate of Du Pont v. Commissioner*, 63 T.C. 746 (1975); *Disbrow v. Commissioner*, T.C. Memo 2006-34. The analysis in *Disbrow* emphasizes the importance of the donor paying fair rental value for the continued use:

> While the presence of a lease may sometimes lead to a finding of a lack of retention for purposes of section 2036(a)(1), see, e.g., Estate of Barlow v. Commissioner, 55 T.C. 666 (1971) (possession and enjoyment of real property pursuant to a lease was not a retention of the possession or enjoyment of the property for purposes of section 2036(a) where the tenant paid FRV), such is not true where, as here, the tenant pays less than FRV as to the lease of the property. Decedent's rights under the lease agreements to the exclusive possession and enjoyment of the residence triggers the application of section 2036(a)(1) to the residence in that decedent did not pay FRV for that possession and enjoyment.

The factual difficulty is establishing the fair rental value of the art. While an active rental market exists for decorative art, there is no rental market for masterpiece artwork. Appraisals are based on facts, and when they are not based on facts, they become merely an opinion. But the leaseback of art is happening every day. The client merely needs to understand that §2036 risk applies because of the inherent factual uncertainty. If a client is going to do this, use someone really good and experienced in dealing with valuable art; the client should use an appraiser that is experienced with rental art.

A case was settled several years ago in which the IRS claimed that corporate art that was displayed in a shareholder's home was treated as a dividend. The amount of the dividend was the fair rental value, but the case settled, so the rental value that was applied is unknown.

(7) **Sales to Grantor Trusts.** Ramsay Slugg summarizes a classic sale to grantor trust structure involving art.

> The main challenges with all of these advanced planning techniques … are first, liquidity, second, valuation, and perhaps the greatest of all, relinquishing possession.
>
> To address these problems, some advisors have taken the following approach with art.
>
> 1) First, the collector contributes the art to an LLC.
>
> 2) The collector then establishes an IDGT, and funds the trust with cash or other assets, typically at least 10 percent of the value of the art.
>
> 3) Next, the collector sells LLC interests to the IDGT and, since the trust is a grantor trust, no capital gain is recognized. The sale is for some cash, perhaps the amount originally funded to the trust, but mostly with a note from the IDGT to the collector.
>
> 4) This is a fairly common wealth transfer technique for high net worth families with other types of assets, especially given low section 7872 interest rates.
>
> 5) Cash to pay the principal and interest on the note will come from the LLC, most of which is owned by the IDGT. The LLC in turn will receive cash from renting the art back to the collector. This rent will be paid pursuant to a lease agreement that sets the rental at a market rate, as determined by appraisal.
>
> 6) On paper, and assuming that all documentation and appraisals are done in a professional manner, this transaction should work effectively. But this transaction is not without significant risks, namely (1) availability of discounting at time of sale of LLC interests to IDGT, (2) determination of fair rental value in absence of an active rental market of high end art, and (3) section 2036 issues, since the collector will at all times retain possession of the art.

e. **Charitable Donation.**

(1) **Lifetime Gift Advantages.** A lifetime donation, rather than a testamentary bequest, allows the personal satisfaction of sharing with the public and gives the donor an income tax deduction.

(2) **Income Tax Deduction Rules.**

(a) **Art Held Over One Year.** Long-term capital gain property gifts to a *public* charity (including operating private foundations, such as a "private" museum, and donor advised funds) may be

deducted at the property's fair market value, up to 30% of the donor's adjusted gross income (AGI). Long-term capital gain gifts to a *private* charity (a non-operating private foundation) other than publicly traded stock qualifies for an income tax charitable deduction only for the cost basis in the asset, up to 20% of AGI.

(b) **Art Held One Year of Less.** Art held for one year or less is short-term capital gain property and subject to the same charitable deduction limitation rules that apply to ordinary income property. Gifts of such art may be deducted to the lesser of fair market value or cost basis, up to 50% of AGI for gifts to a public charity and up to 20% of AGI for gifts to a private charity.

(c) **Unrelated Use.** Gifts of tangible personal property (including art) unrelated to the charity's purpose may be deducted to the extent of the lesser of its fair market value or cost basis, up to 50% of AGI for gifts to a public charity. Examples of related use gifts are a donation of paintings to an art museum for its permanent collection or to a university for viewing or for educational purposes by art students. Related use does not include selling the art and adding the proceeds to the charity's endowment funds. The Pension Protection Act of 2006 added §170(e)(7)(A) that effectively limits the charitable deduction to cost basis if the charity sells the property within three years of receipt, unless the charity provides certification that the property was put to a related use, or at least intended to be put to a related use.

(d) **Fractional Interests.** Donations of partial interests in art (for example, donating some percentage of a painting but keeping all of the copyright) would not be deductible at all for income tax purposes, but donations of fractional interests are deductible, subject to limitations enacted as part of the Pension Protection Act of 2006. Conditions are (1) a donation of the entire interest in the property must be completed by the earlier of ten years from the date of the first fractional interest gift in the property or the donor's death, (2) the value used to determine the charitable income tax deduction (but not the estate or gift charitable deduction) of successive fractional interest gifts in the property is based on the value of the property at the time of the first fractional interest gift in the property, and (3) the charity must take actual possession of the art for its proportionate ownership period.

(e) **Rules of Thumb.** These general rules suggest several rules of thumb for charitable donations of art. First, be careful that donated art has been held for more than one year (or else the deduction is limited to the lesser of fair market value or cost basis, discussed in subparagraph (b) above). Second, give to a public charity or else the deduction is limited to cost basis (discussed in subparagraph (a) above). Third, obtain from the charity a letter specifically stating the intended use of the art (the related use letter is in addition to the other required substantiation, including an appraisal and Form 8382). Fourth, avoid gifts of fractional interests in art unless the donor is committed to satisfying the special conditions for fractional interest donations of art.

(f) **Artist Clients.** The rules are very different for an artist that donates his or her art to or for dealers. The art is not a capital asset to them, and the more restrictive rules for gifts of ordinary income property generally apply (limiting the deduction to the lesser of fair market value or cost basis). For an artist, the art becomes a capital asset at the artist's death.

23. Top Ten Planning Pointers

Ramsay Slugg summarizes his excellent top ten art planning pointers.

1. *Plan.* Do not leave the disposition of the collection to chance.
2. *Use competent and experienced advisors.* Use a complete and competent advisory team.

Professionals always say that, but often do not follow their own advice. The team should include collection experts; such as dealers, gallery owners, curators and restoration experts; risk management professionals; qualified appraisers; private bankers; and attorneys and accountants, all with experience in planning with collectibles. Not only do they need to be on the advisory team, but they need to communicate with one another.

3. *Do appropriate risk management.* Engage an insurance expert who is specifically experienced with your category of collectibles. Whether insurance is purchased or not, collectors should consider the security of their collection, from theft, fire, water, storm, or other casualties.

4. *Prepare and maintain an inventory.* This is true for all assets in the form of financial statements, but it is particularly true with respect to art and other collectibles. This inventory is critical to every stage of the planning process and should be kept as current as possible.

5. *Know the value of the collection.* Insurance providers and lenders, if any, will require appraisals and periodic updates. Appraisals will be required for implementing most of the planning ideas herein. Even if not required, the collection should be periodically valued, perhaps every three to five years, or more often for contemporary or modern art.

6. *Maintain records.* As part of the inventory, maintain records of ownership and, as the value and significance of the collection grows, further evidence of provenance. This includes all contracts to purchase or sell, actual bills of sale, loan agreements with museums, and so on. Consider title insurance if there are doubts about the provenance of any piece being considered for purchase.

7. *Ask the big question.* Involve your family. Do they share your passion? If so, planning should focus on how to transition the collection to them, whether that is now or later. If not, and there are other financial assets or you feel they are otherwise provided for, then explore your charitable options.

8. *Consider charity.* Given the expense of selling, and the opportunity cost of wealth transfer, the "charitable solution" is often the most tax efficient way to keep the collection intact. And if the "charitable solution" is right, consider lifetime donations as this will entitle the collector to a federal income tax charitable deduction in addition to estate tax savings. Most important, do not surprise the museum (or other charity). Not all museums will want the art. It may not fit their collection, or their storage vault. Talk to them now about your wishes, even if they are not carried out until later.

9. *No surprises.* Give the family, and personal representative, clear direction on what the estate will include, and clear direction on what is supposed to happen. And while you are going through the planning process, make sure your advisors know the extent and value of your collection.

10. *Enjoy!* Trying as it may seem, try to enjoy the process of planning for the disposition of your collection. It is certainly not as much fun as building the collection, but it is ultimately just as important.

24. Auction House Sales and Policies

a. **Seller's Agreement.** A sale at public auction or private sale by an auction house will generally be governed by the Seller's Agreement (also referred to as the consignment agreement). Terms of the agreement may be heavily negotiated. The auction house will apply its standard "Conditions of Sale" unless revisions are negotiated.

b. **New York City Rules.** Rules and regulations in New York City illustrate general procedures that apply in public auctions, as summarized by Margaret J. Hoag (Christie's).

New York City Administrative Code, Title 20: Consumer Affairs, Chapter 2: Licenses, Subchapter 13: Auctioneers (the "NYC Auction Regulations"), and Rules of the City of New York, Title 6: Department of Consumer Affairs, Chapter 2: Licenses, Subchapter M: Auctioneers, available here:
https://www1.nyc.gov/assets/dca/downloads/pdf/about/auctioneer_law_rules.pdf

- *License*: The NYC Auction Regulations require that any person engaged in the business of auctioneering be licensed, paying an annual fee accompanied by a surety bond and fingerprints. The auctioneer must conspicuously display her name and license number at any auction site during the sale and on any advertisements, contracts, catalogues and announcements.
- *Statements*: The auctioneer is held responsible for the truth of any statement contained in any catalogue, advertisement, announcement, press release or other public statement made by the auctioneer relating to any auction. Any false or fraudulent representation or statement by the auctioneer or her corporation with respect to the character of any sale or the quality, condition, ownership, value of any lot shall constitute a misdemeanor, punishable by imprisonment or a fine. If an auctioneer's license is revoked for cause, it cannot be reinstated.
- *Contractual Terms*: No lot may be auctioned without a written contract between the consignor (or her agent) and the auctioneer. All fees, commissions and charges to be paid by the consignor must be itemized and specified as to amount or described with particularity. The consignor must warrant that as of the date of the auction, she has complete and lawful right, title and interest in the property to be auctioned and indemnifies

the auctioneer in the event of any defect of title. Each purchaser must receive an invoice with specified information about the lot, the auction and the amounts due.

- *Disclosures:* The auctioneer/auction house must disclose certain situations to the bidding public either in the catalogue or any other printed material, or, if no printed material exists, via a saleroom announcement:
  - If the auction house has any interest, direct or indirect, in a lot, including a guaranteed minimum price,
  - Where a consignor is to receive a rebate commission or is permitted to bid upon and buy back her own consigned lot,
  - If the consignor has a fixed price – the "reserve" – below which she will not agree for the lot to be sold,
  - If the auction house makes loans or advances money to the consignor or prospective purchaser,
  - Except to implement a reserve price, neither the auctioneer nor the consignor may bid for his or her own account if they have access to insider information unless the insider status and intended participation is disclosed in the catalogue and any printed materials and on signs posted at the auction,
  - If a lot's description is printed with an estimate, a general description of the estimate and its meaning must be included in any printed material,
  - Prospective purchasers must be permitted prior to the start of the auction to inspect each lot to be offered for sale.
- *Reserves and Chandelier Bidding:* In no event may the reserve price for any lot exceed the low estimate of the lot. The auctioneer may make or place consecutive or successive bids on a lot on behalf of the consignor up to (but not including the reserve) if that fact that the auctioneer will or may bid in such a manner is clearly and conspicuously disclosed …. Once bidding has reached the reserve price, the auctioneer may not bid on behalf of the consignor or the auction house and may only accept bids from third parties. If the reserve price is not bid, the auctioneer may withdraw a lot from the sale by saying the lot has been "passed", "withdrawn", "returned to owner" or "bought-in".
- *Jewelry-specific*: The lot must be tagged with a correct description, and the catalogue must provide information as to the number of jewels, carats, points, principal metal content and manufacturer's name. The purchaser must receive a signed document containing a description of the lot sold and the representations made in regard at the time of the auction.

c. **Other Laws.** In addition, consignment agreements are subject to other laws such as (1) the Uniform Commercial Code provisions regarding sales of goods, (2) various consumer protection laws (including EU consumer protection laws and the EU General Data Protection Regulation), and (3) U.S. Bilateral Agreements regarding "cultural property."

25. Art Litigation Issues

a. **Major Categories of Disputes.** The major categories of litigated art disputes involve title, consignments, authenticity, copyright, tax and regulatory issues, and looted art, as well as other concerns.

b. **Title.** In the United States, the reason that title is defective generally does not matter—the true owner will prevail in a dispute. "A thief cannot pass good title." (A different approach applies in many European and civil law countries, which are more protective of good faith purchasers.)

c. **Venue and Choice of Law.** The consignment agreement may include choice of venue and choice of law provisions. These can be important provisions. Statutory provisions regarding consignments can vary in important respects among the states.

d. **Inflection Points.** Litigation often arises upon the occurrence of certain inflection points, such as sales, gifts, or exhibitions of art. Be aware that the decision to engage in such activities could potentially give rise to litigation.

e. **Authenticity.** Authenticity and provenance are related. The provenance of a piece of art gives clues as to whether concerns about authenticity exist.

Many foundations that focus on a particular artist no longer provide authentication opinions regarding that artist's works for fear of being sued. Plaintiffs "never" win lawsuits against the institution that provides the opinion, but the litigation is expensive.

f. **Agency.** Issues can arise as to whether someone is an agent on behalf of and owes duties to a particular purchaser or seller. Whether someone is or is not an agent should be made clear in writing.

g. **Nazi Stolen Art.** In the last 30 years, the scope of Nazi stolen art and how it was dispersed has become a central focus in litigation over the ownership of such art. Auction houses are the gatekeepers of that issue; they will hold pieces in dispute until the dispute is resolved. The period of suspicion begins in January 1933. If a piece was not out of Germany before then, ownership issues may be in dispute. Do not assume that ownership statutes of limitation have run if art was potentially stolen in the Nazi era. The U.S. Supreme Court is currently considering whether claims of Nazi property takings from German Jews are subject to jurisdiction under the Foreign Sovereign Immunities Act. *Federal Republic of Germany, et al. v. Alan Philipp, Gerald Stiebel, and Jed Leiber* (Cause No. 19-351). (Panelist Nicholas M. O'Donnell is counsel of record for respondents in that case.)

26. Resources

Ramsay Slugg suggests the following as excellent resources regarding art planning.

Lerner, Ralph E., Judith Bressler, and Diana Wierbicki. *Art Law. 5*th ed. New York: Practising Law Institute, 2020. The most comprehensive work on all aspects of art law.

Slugg, Ramsay H., *Handbook of Practical Planning for Artists, Art Collectors and Their Advisors, 2d Edition*, American Bar Association, 2019.

Mendelsohn, Michael. *Life is Short, Art is Long.* 2nd ed. Acanthus Publishing, 2006 – 2007. A comprehensive treatment of the topic….

For an additional summary of art planning considerations, see the summary of an outstanding panel discussion about art planning in ACTEC 2015 Summer Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**).