ACTEC 2021 Annual Meeting Musings

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This summary reflects brief highlighted individual observations of Steve Akers from the seminars at the 2021 Annual Meeting and does not purport to represent the views of ACTEC as to any particular issues.

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Introduction

Some of my brief observations from the 2021 ACTEC Annual (Virtual) Meeting Seminars on March 8-11, 2021, are summarized below. (At the request of ACTEC, the summary does not include any discussions from Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely selected issues from the seminars. The summary is based on the presentations at the seminars, but the specific speakers making particular comments are not necessarily identified. Some of the comments are updated with developments that have occurred after the ACTEC 2021 Annual Meeting.

Items 1-13 are observations from a seminar by Tasha K. Dickinson, Paul S. Lee, Carlyn S. McCaffrey, and Prof. Mary E. Radford, Hot Topics

1. Potential Legislative Changes

a. **Predictions About Which Tax Reform Measures Will be Adopted.** Paul Lee offered predictions about which of the tax reform measures being proposed by the Biden administration may be adopted.

(1) **Individual Income Tax Provisions.** The Biden administration proposals regarding individual income taxes include increasing the top marginal rate from 37% to 39.6%, restoring the Pease limitation for taxpayers with income over $400,000, and applying a maximum 28% benefit for deductions. Those will all likely happen before 2026.

(2) **Corporate Tax Rate.** The administration proposes increasing the corporate tax rate from 21% to 28%. This will likely be compromised at a 25% rate.

(3) **Section 199A Deduction.** The administration proposes eliminating the §199A deduction for taxpayers with income over $400,000. This is unlikely to pass. The vast majority of small business owners who used this deduction only lowered their effective tax rate on the income from flow-through entities from 37% to about 34% or 35%. Eliminating this deduction would be controversial, and "why get rid of something early that is not moving the meter much anyway?".

(4) **Transfer Tax Exclusion Amounts.** The large $10 million (indexed) gift, estate, and GST exemption is likely to be reduced prior to the 2026 sunset date, but it is likely to be reduced to $5 million (indexed) rather than to $3.5 million as proposed by the administration. The gift exemption will likely remain the same as the estate exclusion amount rather than being reduced to $1 million.

(5) **GRATs.** It is "highly probable" that the GRAT proposals from the Obama administration will be adopted. These include a 10-year minimum term with a remainder interest valued at the greater of 25% of the amount contributed to the GRAT or $500,000 (up to the value of property in the trust).

(6) **GST Exemption Time Limit.** The Obama administration supported a time limit for the GST exemption on trusts of 90 years, and the Sanders "For the 99.5 Percent Act" proposes a 50-year maximum term for existing trusts to keep an inclusion ratio less than 1.0. Trusts created after the date of enactment that do not have a termination date within 50 years would have an inclusion ratio of 1.0 from the outset. Paul predicts that some time limit on GST exempt trusts will be adopted.

(7) **Carried Interest.** Section 1061 imposes a three-year holding period to get long-term capital gain treatment on carried interests. That is not a huge penalty. Most people believe that carried interests should be taxed as ordinary income.

(8) **Capital Gain Rates.** The administration proposes taxing capital gains at ordinary income rates (in addition to the 3.8% tax on investment income) for taxpayers with over $1 million of income. Thus, the federal rate would be 43.4%, and the combined federal and state income tax rate could be well over 50% (it could be 56.7% in California).

The administration has not made clear how "income" would be determined for that purpose, but it is probably adjusted gross income with possible other further adjustments. It is also unclear whether the $1 million would be a cliff rule causing all capital gains income to be taxed at ordinary income rates or only income in excess of $1 million.

A Penn Wharton budget model estimates that merely doubling the capital gains rate on taxpayers with income over $1 million would actually decrease federal revenue over fiscal 2022-2031, but if Congress also ended basis step-up at death, raising the capital gains rate to 39.6% would instead raise $113 billion over the same time-frame. *See* Colin Wilhelm, *Capital Gains Hike Faces Budget Issue Without Other Changes*, BLOOMBERG DAILY TAX REPORT (April 23, 2021).

This proposal may motivate some taxpayers to recognize gains currently when rates are lower than what they may become. One alternative is to sell an asset for installment payments. When the transaction is reported on the income tax return filed in the following year, if rates have increased on capital gains, the taxpayer could elect out of installment sale treatment. Another alternative is a "short against the box" transaction that triggers gain recognition under §1259; a taxpayer would have 30 days after the taxable year to undo the short which would undo the constructive gain recognition. Another possibility is for family members to exchange securities that are materially different from each other. Gain recognition occurs but the family as a whole is not out of the market.

A planning impact of a substantial increase in the capital gain rate is that taxpayers would be motivated to make charitable contributions of highly appreciated securities.

Paul predicts that the end result will be a long-term capital gains rate for high income taxpayers of 28%. (The 1986 Tax Reform Act provided a 28% long-term capital gains rate.) This prediction is supported by Marc Goldwein, senior policy director for the Committee for a Responsible Federal Budget, who predicts that the capital gains rate will be increased to "something more like 28%" because of the political complications of changing the way capital gains taxes apply at death. *See* Colin Wilhelm, *Capital Gains Hike Faces Budget Issue Without Other Changes*, BLOOMBERG DAILY TAX REPORT (April 23, 2021).

(9) **Eliminating Basis Step-Up at Death.** The Biden administration proposes ending the step-up in basis at death on capital gains exceeding $100,000. The administration is still working on the details of the proposal but one recent guestimate is "a $1 million cap on what can be passed along without paying the proposed top capital gains rate, as well as a smaller cap—likely $400,000—to avoid paying capital gains at all." *Id*. That would be a huge revenue generator. Some commentators predict a 25% to 33% likelihood of passage (though the exemption amount may be larger than $100,000). This would likely be a modified carryover basis system; debt in excess of basis at death would not trigger gain recognition at death.

Following the Annual Meeting, the White House released a "Fact Sheet" on April 28, 2021regarding the proposed American Families Plan that includes a paragraph titled "End capital income tax breaks and other loopholes for the very top." It proposes that households making over $1 million will pay the top 39.6% rate on capital gains and dividends and

> ending the practice of "stepping-up" the basis for gains in excess of $1 million ($2.5 million per couple when combined with existing real estate exemptions) and making sure the gains are taxed if the property is not donated to charity. The reform will be designed with protections so that family-owned businesses and farms will not have to pay taxes when given to heirs who continue to run the business.

This suggests that no basis step-up would be allowed for gains in excess of $1 million per person and also hints that it also contemplates a deemed realization system upon making gifts or at death.

(10) **Deemed Realization at Death or Upon Making Gifts.** On March 29, 2021 (following the Annual Meeting), Rep. Bill Pascrell, Jr. (D-New Jersey) introduced H.R. 2286 and Senator Chris Van Hollen (D-Maryland) published a discussion draft of statutory language titled the "Sensible Taxation and Equity Promotion ("STEP") Act of 2021," These proposals would generally treat property transferred by gift or at death as sold for fair market value. Both proposals would tax

past appreciation, not just appreciation following enactment. Exceptions would apply for transfers of tangible personal property and transfers to spouses and charities. Special rules would apply for grantor trusts. Non-grantor trusts generally would be treated as sold at established intervals (30 years in the House version and 21 years in the Senate draft). Extensions would be available for paying the tax attributable to certain types of assets other than actively traded personal property.

As discussed immediately above, the proposed American Families Plan also appears to include a deemed realization proposal.

b. **Senator Sanders' "For the 99.8 Percent Act" (2019) and "For the 99.5 Percent Act" (2021).** Senator Sanders on January 31, 2019 introduced S. 309 titled "For the 99.8 Percent Act," and on March 25, 2021 (following the Annual Meeting) introduced S. 994, titled "For the 99.5 Percent Act." The 2019 and 2021 proposals are very similar (identical in most respects). These proposals would reduce the basic exclusion amount to $3.5 million (not indexed) for estate tax purposes and to $1.0 million (not indexed) for gift tax purposes and increase the rates, ranging from 45% for estates over $3.5 million to 77% (2019 proposal)/65% (2021 proposal) for estates over $1 billion. (The GST tax rate is not specifically addressed, so presumably it would be the highest marginal estate tax rate of 77%/65% under §2641(a)(1), with a $3.5 million GST exemption.) The 2021 bill is available **here**.

The bill also would make dramatic changes to the transfer tax system including relaxation of special use valuation and conservation easements provisions, elimination of discounts for nonbusiness assets and passive assets, elimination of minority discounts if the family controls the entity, restrictions on GRATs, inclusion of grantor trust assets in the gross estate, limiting GST exempt trusts to a maximum of 50 years, and "simplification" measures for the gift tax annual exclusion.

The effective dates are very important. The effective date is generally the date of enactment, except that the rate and exemption changes and the special use valuation and conservation easement relaxation provisions are effective January 1 of the following year. The grantor trust provision applies to trusts created on or after the date of enactment, and to the portion of prior trusts attributable to post-date-of-enactment "contributions" (which does not explicitly include sales) to the trust and attributable to post-date-of-enactment sales in nonrecognition transactions with a deemed owner trust under §678.

Senator Sanders wanted a cabinet level position, but he could not leave the Senate without changing control of the Senate. Accordingly, he could have bigger sway in the future as Chairman of the Senate Budget Committee.

2. Transfer Planning in Light of Legislative Uncertainty

a. **GRATs.** Using GRATs while they are still available makes sense. Consider classic two-year GRATs, but also consider longer-term GRATs.

b. **Concerns With Making Gifts.** Clients may have the following concerns with making gifts in light of legislative uncertainties.

(1) **Retroactive Gift Exemption Decrease.** A retroactive decrease of the gift tax exemption amount and an increase in rates could result in unexpected gift tax.

(2) **Highly Appreciated Assets.** A client may not have assets suitable for gifting because the assets are highly appreciated. The loss of a basis step-up at death may outweigh the advantage of excluding post-transfer appreciation from the gross estate.

(3) **Depreciating Assets.** If assets decline in value, the gift is counterproductive.

(4) **Lifestyle Needs**. The client may be reluctant to give assets that may be needed in the future to support the client's own lifestyle.

c. **Guarding Against Retroactive Gift Tax Changes.**

(1) **Disclaimer With Reversion to Donor.** The "most often mentioned" alternative is to give assets to a trust providing that a disclaimer by the primary beneficiary or trustee would cause assets to

revert to the donor. The disclaimer would have to be made within nine months after the gift. A major disadvantage is that the donor must rely on compliance by the beneficiary to make the disclaimer if a retroactive gift tax increase occurs.

The disclaimer could be made either by the primary beneficiary of the trust or by the trustee. Some have expressed concerned with a breach of fiduciary duties by a disclaiming trustee, but Carlyn McCaffrey is not overly concerned if the trust agreement makes the settlor's intent clear and the trustee is taking steps to carry out the settlor's intent by making the disclaimer.

(2) **Gift to Spouse (or QTIP Trust) With Disclaimer by Spouse Causing Transfers to Descendants.** The gift might be made to the donor's spouse outright or to a trust for the spouse (perhaps a QTIPable trust), and the transfer might provide that in the event of a disclaimer by the spouse the assets would pass to a trust for descendants. The donor might be more comfortable relying on the spouse to carry out the disclaimer than relying on the donor's children.

(3) **QTIPable Trust.** The donor could make a gift to a QTIPable trust and make the QTIP election if a retroactive gift tax change is made, so that the transfer would not result in a taxable gift. Advantages of this approach are that (1) the donor is control of the decision of whether to avoid having a taxable gift if retroactive legislation occurs, and (2) a longer period of time for making the decision applies (to October 15 of the following year if the gift tax filing date is extended rather than nine months from the transfer with the disclaimer approach). Disadvantages are that all net income must be paid to the spouse and the spouse can be the only beneficiary of the trust for the spouse's lifetime.

(4) **Sell Assets for a Note.** The client could sell assets to a grantor trust for a note and later forgive the note if retroactive gift tax legislation does not occur.

(5) **Formula Gift.** A formula transfer, based on whether retroactive gift tax changes are made, has superficial appeal. It is similar to a defined value transfer, except that a defined value transfer results in a clear current transfer. The value actually exists on the date of the gift (though it may be hard to determine). A formula gift based on future legislation means that one cannot determine, even theoretically, the transfer on the date of the gift.

d. **Planning for Client With Only Highly Appreciated Assets for Gifts.** Give some third party the power to give the donor a limited power of appointment if a basis step-up appears to be more valuable than estate exclusion. The mere existence of the power to grant the power of appointment should not cause inclusion under §2038, because it depends on a contingency outside the donor's control. If, after granting the donor a limited power of appointment, estate exclusion is subsequently determined to be more desirable than basis step-up, the third person could revoke the power of appointment. The three-year rule of §2035 would not apply because the grantor would not have affirmatively relinquished the problematic power.

e. **Concern With Future Lifestyle Needs.**

(1) **SLAT.** The gift could be made to a spousal lifetime access trust (SLAT) with the donor's spouse as a discretionary beneficiary. Disadvantages are that (1) the marriage to the spouse may not be a happy marriage in the future, and (2) the donor may lose indirect access to the assets if the spouse predeceases the donor (but the trust might give the spouse the power to appoint assets to a trust including the original donor as a discretionary beneficiary if under local law that does not give the donor's creditors access to the trust assets).

(2) **Promise to Make Gift.** Instead of giving hard assets, the client might merely make a gift of an enforceable note. However, such notes, without consideration, may be enforceable only in Pennsylvania (and the client might consider establishing a Pennsylvania trust with a Pennsylvania trustee and relying on Pennsylvania law; some institutional trustees in Pennsylvania will serve as trustee for a small annual fee in that situation). Also, theoretically, the gifted note could be given in exchange for consideration (for example, that the donee read a good book a month for the next year).

Revenue Ruling 84-25 says that a gratuitous transfer of a legally binding promissory note is a completed gift. If the donor dies when the note is still outstanding, the estate is not entitled to a §2053 debt deduction for the note owed by the estate, because it was not contracted for full consideration. But the IRS reasoned in Rev. Rul. 84-25 that the assets that would be used to pay the note are still in the donor's gross estate, so the gift of the note would not be an adjusted taxable gift to be added back into the estate tax calculation. §2001(b) (last sentence). Do not make the split gift election, though, because only the donor's gift exclusion amount would be restored, not the spouse's, if the donor dies before the note is paid.

If the IRS were to pass a regulatory anti-abuse rule under the anti-clawback regulation for gifts that are included in the gross estate, the gift by promise would likely not get the benefit of the anti-clawback rule because the assets that will be needed to pay the liability are still in the gross estate. A planning alternative, if that were to occur, would be for the donor to pay the promised gift amount before death. *See* Katie Lynagh, *Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion*, BNA ESTATES, GIFTS & TRUSTS J. (May 14, 2020).

(3) **Intentionally Defective Preferred Interest.** The client might transfer assets to an LLC with a common and noncumulative preferred interest. The client would retain the preferred interest, which would give the client the ability ultimately to receive the full amount contributed to the LLC. Under §2701, the preferred interest would be valued at zero and the client would be treated as having made a gift of the full amount contributed to the LLC. Advantages are that (1) the client can recover the assets transferred to the LLC when needed by the client, (2) the client makes use of the large exemption amount during the "window of opportunity" before 2026, and (3) appreciation in the assets inures to the benefit of the gifted growth interest in the LLC. A disadvantage is that future regulations may disallow the enhanced credit at death (for gifts included in the gross estate), but the client could make a gift of the preferred interest to avoid that bad result.

3. Estate Tax Closing Letters – Proposed User Fee

On December 28, 2020 the IRS released a proposed regulation that would impose a new $67 user fee to request an estate tax closing letter (IRS Letter 627). Prop. Reg. §300.13. The new system would apply to requests received by the IRS 30 days after the publication of a final regulation.

On one hand, planners are glad for the IRS to return to a system for a simplified process for requesting an estate tax closing letter. On the other hand, taxpayers are now going to have to pay the IRS to do its duty when the letter is needed because of the potential liability imposed by the government on the fiduciary in the first place. Fee creep is another concern. (In January, the IRS announced in Rev. Proc. 2021-1 that the general fee for obtaining a private letter ruling increases from $30,000 to $38,000 in 2021.)

The American Institute of CPAs has suggested to the IRS that it add a box to check on the next version of Form 706 and Form 706-NA for the executor to request a closing letter at the time of filing the estate tax return.

For further discussion of this issue, see Item 6.a(1) of Estate Planning Current Developments and Hot Topics (March 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

4. Life Expectancy Tables

a. **Tables for Minimum Required Distributions From Retirement Plans.** The IRS issued final regulations November 4, 2020 (T.D. 9930, published in the Federal Register on November 12, 2020) revising the life expectancy tables used for calculating minimum required distributions from retirement plans and IRAs under Reg. §1.401(a)(9)-9(b)-(c). The effective date was moved back to plan years beginning on or after January 1, 2022. The new tables reflect life expectancies that are generally between one and two years longer than under the existing regulations.

Actuarial Tables Under Section 7520. The §7520 actuarial tables were not updated by May 1, 2019, as required by §7520. The IRS has been waiting on data from another agency, and that data now appears to be available. On August 7, 2020, the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011, which apparently is the underlying data for the IRS actuarial tables. (On October 1, 2020, the report was revised to correct a programming error that had affected the probabilities reported for persons under one year old.) The new Lx table reflects a significant increase in life expectancy, compared to the tables that were last issued in 2009.

The Lx table lists the number of individuals, out of a total of 100,000, who will be alive at each of ages 0-110, based on data from the 2010 census (which obviously is already 10 years old). The new data reflects a somewhat remarkable increase in life expectancies compared to the existing Lx table (based on 2000 census data). For example, at age 84 the number of individuals, out of a 100,000 starting pool, expected to be surviving has increased from 37,837 to 44,809, an 18.4% increase in just 10 years.

The new tables will result in a larger charitable deduction for CLATs for the life of an individual, but a lower deduction for a CRAT (and more difficulty in satisfying the 10% remainder test and 5% exhaustion test for a CRAT) and for the remainder interest in a personal residence after a retained life estate.

Presumably, proposed regulations with the new tables will be coming soon. The effective date will be interesting. For example, may the new tables be used from April 30, 2019 when they were required?

b. **Additional Discussion.** For additional discussion of these new tables, see Items 3.d and Item 6.a(2) of Estate Planning Current Developments and Hot Topics (March 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

5. Using Electronic Signatures on Tax Forms

On August 28, 2020, the IRS announced that it would temporarily accept the use of digital signatures on certain forms that cannot be filed electronically. Additional forms were added to that list on September 10, including Forms 706, 706-NA, 709, 3520, and 3520-A. An IRS memorandum dated December 28, 2020 allows using electronic or digital signatures for those forms (and other listed forms) through June 30, 2021, and a memorandum dated April 15, 2021 (Control Number: NHQ-10-0421-0002) extends that permission through December 31, 2021 for forms that are signed and postmarked on or after August 28, 2020.

The forms covered by those notices do not include Form 2848 (which taxpayers use to authorize a professional to represent them before the IRS) or Form 8821 (authorizing others to view tax return information). A “wet signature” is required on those forms that are submitted by mail or fax, but a PDF of a signed form can be submitted through an online portal (but the planner must have an e-Services account with the IRS to use that online portal).

6. Remote Notarization and E-Wills

a. **Remote Notarization.** Virginia was the first state that allowed remote online notarization in 2012. Florida in 2019 passed a remote notarization statute, effective in January 2020.

b. **Electronic Wills.** The Uniform Electronic Wills Act was adopted in 2019. (Nevada began recognizing electronic wills in 2017, and Florida began recognizing them in July 2020.) Electronic wills provisions are being considered in various states. The statutes vary in how the signatures of the signer and witnesses are authenticated.

7. John Doe Summons Upheld to Determine Identity of Law Firm’s Clients Seeking Advice Regarding Particular Issues, *Taylor Lohmeyer Law Firm P.L.L.C. v. United States*

A client of the Lohmeyer law firm was audited and paid taxes and penalties regarding the assignment of income to foreign accounts. The IRS issued a “John Doe summons” to the law firm to disclose the names of all clients over a 12-year period that had used the law firm's services regarding establishing any foreign account, any foreign legal entity, or any asset in the name of any such foreign entity.

The law firm acknowledged the general rule that a client's identity is not protected from the attorney-client privilege and is subject to subpoena but argued that an exception applies when disclosure of the identity necessarily discloses the substance of the legal advice.

The Fifth Circuit upheld the subpoena in a three-judge panel decision and voted 9-8 not to grant an *en banc* rehearing without giving any reasons despite a strong eight-judge dissenting opinion expressing concerns about the impact of the decision on the attorney-client privilege. *Taylor Lohmeyer Law Firm P.L.L.C. v. United States*, Cause No. 19-50506 (December 14, 2020).

The American College of Tax Counsel filed an amicus brief expressing concern that the IRS could make broad requests to law firms to circumvent the attorney-client privilege.

For further discussion of this case, see Item 24 of Estate Planning Current Developments and Hot Topics (March 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

8. Charitable Gift Followed by Redemption Not Treated as Anticipatory Assignment of Income, *Dickinson v. Commissioner,* T.C. Memo. 2020-128 (Sept. 3, 2020)

a. **Basic Facts.** In 2013, 2014, and 2015, the board of directors of a privately held company authorized donations of shares to the Fidelity Gift Fund because the Gift Fund had a written policy requiring that it immediately liquidate donated shares and would promptly tender the donated stock to the issuer for cash. The taxpayer donated shares to the Gift Fund in those years, and the Gift Fund immediately had the shares redeemed by the company. The IRS claimed that the redemptions resulted in an assignment of income, as if the shareholder first sold the shares (realizing gain) and then contributed the cash to the Gift Fund.

b. **Two-Part Test.** The court concluded that the assignment of income doctrine applies "only if"

(1) "the redemption was practically certain to occur at the time of the gift," and

(2) "would have occurred whether the shareholder made the gift or not."

The first leg probably was satisfied on these facts, considering Fidelity's strict written policy that it would immediately sell such donated stock. But the second leg was not satisfied; there was no indication whatsoever that the taxpayer would have sold shares to the corporation if the shares had not been donated to the Gift Fund.

The court refused to apply the "legally bound" test of Rev. Rul. 78-197.

c. **Documentation.** The court pointed to documentation from the corporation, the taxpayer, and the Gift Fund evidencing that the Gift Fund had full ownership and discretion over the shares and whether they would be sold.

9. FLP Assets Included Under §2036(a)(1); Application of §2043 Consideration Offset; Formula Transfer to Charitable Lead Trust Not Respected; Loans Not Respected; No Deduction for Attorney's Fee, *Estate of Howard V. Moore v. Commissioner,* T.C Memo. 2020-40 (April 7, 2020)

a. **Very Brief Overview of Facts.** In a very convoluted pre-death planning scenario, the decedent (knowing he had less than six months to live) transferred 4/5ths of a farm (that he had already contracted to sell) to an FLP in return for a 95% limited partnership interest. He subsequently sold the 95% interest to an irrevocable trust for a cash down payment and $4.8 million note at a price representing a discount of about 50%.

The decedent's revocable trust provided a formula bequest to a charitable lead trust in an amount to "result in the least possible federal estate tax." In addition, the Irrevocable Trust provided that the trustee would distribute to the revocable trust "the value of any asset of this trust which is includible in my gross estate."

b. **Estate Inclusion Under §2036(a).** Not surprisingly, the court determined that the farm was included in the gross estate under §2036(a)(1). The bona fide sale for full consideration exception in §2036(a) did not apply because no businesses required active management, the children did not actually manage sale proceeds in the FLP, no legitimate creditor concerns existed, and the "whole plan" involving the FLP had a "testamentary essence." The decedent retained enjoyment or possession of the assets transferred to the FLP under §2036(a)(1) (at least by implied agreement) because, although he kept sufficient assets for personal needs, he instead "scooped into FLP assets to pay personal expenses," and his relationship to the assets remained unchanged after the transfer to the FLP.

c. **Section 2043 Consideration Offset Discussion.** The court followed up on the discussion of §2043 in *Estate of Powell v. Commissioner* with its own lengthy analysis, but on the facts of the case the application of §2043 had little practical impact. The §2043 analysis makes no sense from a tax policy perspective.

d. **Charitable Formula Transfer Provision Not Respected.** The court refused to allow any additional charitable deduction under the formula transfer provision in the Irrevocable Trust as a result of the inclusion of the farm in the gross estate because (1) specific wording in the formula limits any transfer and (2) the charitable amount was not ascertainable at the decedent's death but depended on subsequent events (the IRS audit and tax litigation). The *Christiansen* and *Petter* cases were distinguished because they merely involved valuation issues to determine what passed to charity, but in this case the charity did not know it "would get any additional assets at all."

e. **Additional More Detailed Discussion.** For a more detailed discussion of the *Estate of Moore* case, see Item 20 of Estate Planning Current Developments and Hot Topics (March 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

10. In Determining Value of Nonvoting Interests in LLCs, Tax Court Repudiates IRS Valuations That Assumed the Voting Interest Would Also Be Acquired in the Same Willing-Buyer-Willing-Seller Transaction, *Grieve v. Commissioner*, T.C. Memo. 2020-28 (March 2, 2020)

a. **Very Brief Synopsis.** *Grieve v. Commissioner* upheld a donor's gift tax valuation of 99.8% nonvoting interests in two limited liability companies that he had given in 2013 to a GRAT and to another irrevocable trust (in return for a private annuity). The assets held by the LLCs were largely cash, cash equivalents, and marketable securities. The donor's gift tax return applied entity-level discounts for lack of control and marketability totaling about 35%.

b. **"Game Theory" Approach Rejected of Assuming That Hypothetical Purchaser Would First Acquire Voting Interest.** The court rejected the IRS's appraiser's approach of assuming that a hypothetical purchaser of the 99.8% non-voting units would first purchase the 0.2% voting units, reasoning that such assumption was not reasonably probable and the court would "not engage in imaginary scenarios as to who a purchaser might be," quoting this guidance from *Olson v. United States* (292 U.S. 246, 257 (1934)):

> Elements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable should be excluded from consideration for that would be to allow mere speculation and conjecture to become a guide for the ascertainment of value--a thing to be condemned in business transactions as well as in judicial ascertainment of truth.

c. **Additional Detailed Discussion.** For a more detailed discussion of *Grieve*, see Item 19 of Estate Planning Current Developments and Hot Topics (March 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

11. Treatment of Advances to Son as Legitimate Loans vs. Gifts, *Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71 (June 1, 2020)

a. **Brief Synopsis.** The Tax Court addressed whether advances from a mother to her children (and particularly, over $1 million of advances to a struggling son) were legitimate loans or were gifts. Although the mother documented the advances, there were no loan agreements, security, or attempts to force repayment. She forgave the "gift tax exemption amount" of the debts each year. Large amounts were advanced to a struggling son ($1,063,333 over 23 years), and at some point, the mother realized that the son would never be able to repay the advances; on October 27, 1989, she prepared her revocable trust to exclude that son from any distribution of her estate at her death. The court treated advances through 1989 as loans but treated subsequent advances as gifts.

b. **Additional Detailed Discussion.** For an additional discussion of *Estate of Bolles*, see Item 21 of Estate Planning Current Developments and Hot Topics (March 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

12. Gift and Sale of Partnership Interests Expressed as Dollar Amounts Based on Subsequent Appraisals; Lack of Control and Lack of Marketability Discounts Determined With Multi-Tiered Discounts, *Nelson v. Commissioner*, T.C. Memo. 2020-81 (June 10, 2020)

a. **Brief Synopsis.** This gift tax case determined the value of gifts and sales of interests in a limited partnership, the primary asset of which was 27% of the common stock of a holding company that directly or indirectly owned 100% of eight subsidiaries (six of which were operating businesses). The gifts and sales were of limited partner interests having a specified dollar value on the transfer date "as determined by a qualified appraiser within ninety (90 days) of the effective date of the Assignment" (180 days in the case of the sale). An appraisal was prepared for the holding company, which was then used to prepare an appraisal for the transferred limited partner interests. The percentage limited partner interests that were transferred were based on those appraisals and documented in the partnership's records and used for preparing subsequent income tax returns.

The IRS took the position that the transfers resulted in additional gifts of about $15 million. The taxpayers first argued that the transfers were actually of interests worth a particular dollar value as finally determined for federal tax purposes rather than of particular percentage interests. The court disagreed, observing that the clauses in the assignments "hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes."

> **Observation:** This is a practical approach that is often used in structuring assignments of hard-to-value assets. The IRS did not object to this type of assignment (determining the percentage interest transferred on the basis of an appraisal completed relatively soon after the transfer) as abusive, but merely proceeded to enforce the assignment as drafted and then value the interests so transferred.

The court ultimately determined that the 27% interest in the holding company that the partnership owned was valued using a 15% lack of control discount (slightly lower than the taxpayers' expert's position of a 20% discount but higher than the IRS's expert's 0% discount) and 30% for lack of marketability (agreed to by experts for both the taxpayers and the IRS). The holding company value was then used to determine the value of the limited partner interests, which the court determined using a 5% lack of control discount (compared to 15% by the taxpayer's expert and 3% by the IRS's expert) and a 28% lack of marketability discount (compared to 30% by the taxpayers' expert and 25% by the IRS's expert). The values determined by the court resulted in an additional gift value of about $4.5 million. On October 16, 2020, Mr. and Mrs. Nelson filed notices of appeal of the Tax Court's decision to the Court of Appeals for the Fifth Circuit.

b. **Additional Detailed Discussion.** For an additional discussion of *Nelson*, see Item 22 of Estate Planning Current Developments and Hot Topics (March 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

13. Valuation of Majority Interests in LLCs Owning Real Estate; Estate Tax Charitable Deduction Based on Values Passing to Each Separate Charity, *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (February 18, 2021)

a. **Brief Synopsis.** Ms. Warne died owning majority interests in LLCs that held real estate investments. The court determined the values of three leased fee interests at the date of a gift and at the date of death and determined appropriate lack of control and lack of marketability discounts for the LLC majority interests owned at death (all over 70% and three over 80%). The operating agreements all gave significant powers to the majority interest holders (including the power to dissolve the LLCs and to remove and appoint managers). Ms. Warne owned 100% of one LLC at her death, which she left 75% to a family foundation and 25% to a church. The real estate interests were substantial; the remaining LLC interests owned by Ms. Warne at her death were valued on her estate tax return at about $73.7 million. The parties agreed on most of the values, but the court determined the values of three leased fee interests at the date of the gift and at the date of death.

The estate argued that the 100% interest in the LLC that was left to two charities should be completely offset by the estate tax charitable deduction (because the 100% interest was donated entirely to charities), but the court concluded that a charitable deduction was allowed only for the value passing to each charity. The parties had agreed that a 27.385% discount applied for the 25% passing to the church and a 4% discount applied for the 75% passing to the foundation. (Applying discounts to the charitable deduction reduced the charitable deduction by over $2.5 million.)

b. **Reliance on *Ahmanson*.** The court relied largely on *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981), in support of its reduction of the charitable deduction. In *Ahmanson*, the decedent owned the one voting share and all 99 nonvoting shares of a corporation. The voting share was left to the decedent's sons and the 99 nonvoting shares were left to a charitable foundation. The gross estate value of the 100 shares took into consideration that the decedent held full voting control of all of the shares, but "the estate's deduction attributable to the donation of the 99 nonvoting shares necessitated a 3% discount to account for the foundation's lack of voting rights." The fact that the asset in *Ahmanson* was split between an *individual* and a charity rather than between two charities made no difference to the court because that did not affect the value of the church's and foundation's respective interests that they received "and it is the value of the property received by the donee that determines the amount of the deduction available to the donor."

c. **Criticism of Result on Policy Grounds.** The ability to avoid the reduction of the charitable deduction under the *Warne* analysis merely by leaving the asset first to a foundation or donor advised fund, which could then distribute the asset to multiple charities, raises the question of the policy rationale of denying a full charitable deduction when an asset is left in its entirety to multiple charities. The court rejected the estate's attempt to distinguish *Ahmanson* because it involved splitting an asset between an *individual* and a charity rather than between two charities. The estate argued that applying discounts when the asset passed entirely to charities "would subvert the public policy of motivating charitable donations" and that leaving 100% of the LLC to charities should entitle the estate to a deduction of 100% of the value of the LLC. The court disagreed, focusing on allowing a charitable deduction for the value received by each donee.

Commentators have questioned the public policy rationale of denying a full charitable deduction when an asset is left entirely to charity, whether that is one charity or multiple charities, and suggesting that the case should be appealed for that reason:

> Unlike in *Ahmanson Foundation,* the decedent in *Warne* did not adopt a testamentary plan severing the voting power of Royal Gardens from its economic entitlement and then give only an economic entitlement to charity. Nor did she take any other affirmative steps to diminish the value ultimately passing to charity. Instead, the decedent merely gave a 75% membership interest in Royal Gardens to one charity and the remaining 25% membership interest to another charity. Query whether the purpose of the charitable deduction of encouraging charitable gifts would be any better effectuated by requiring the decedent in this situation to give her entire interest in Royal Gardens to either her family foundation or to her church, rather than allowing her to allocate such interests among charities as she desires?
>
> …
>
> Query what the result would be where an individual who owns a $10 billion art collection gives at his or her death a 50% fractional interest in the collection to the Metropolitan Museum of Art and the remaining 50% fractional interest to the National Gallery of Art? The $10 billion would clearly be included in his gross estate but should the charitable estate tax deduction be any less than the same $10 billion included in the gross estate? Any valuation discount applied in determining the charitable estate tax deduction on the basis of what is actually received by the charities would result in significant estate taxes being imposed merely because the decedent desires for the collection to be displayed at two of the country's great museums following his death. Would the purpose of the

charitable deduction be better served by requiring the collection in such a case to be given to only one of the museums? Richard L. Fox & Jonathan G. Blattmachr, Estate of Miriam M. Warne - *Decedent's Splitting of Charitable Bequest of 100% LLC Membership Interest Between Two Separate Charities Results in Mismatch of Value Included in Gross Estate and Amount Allowed As Estate Tax Charitable Deduction*, LEIMBERG CHARITABLE PL. NEWSLETTER #306 (March 1, 2021).

d. **Additional Detailed Discussion.** For an additional discussion of *Estate of Warne*, see Item 26 of Estate Planning Current Developments and Hot Topics (March 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

Items 14-26 are observations from a seminar by Dr. Laurie Santos, Professor of Psychology and Cognitive Science at Yale University, Happiness and the Good Life – What Estate Planners Need to Know

14. Background; Replay

A course that Dr. Santos teaches at Yale, The Science of Well-Being, is the most popular college course at Yale. One-fourth of the entire Yale student body has tried to take her class. Indeed. Dr. Santos has made the course available to the public and over 3.3 million people have taken that course. Dr. Santos takes a data and evidence-based approach to discuss well-being and what steps individuals can take to bring happiness. The Symposium by Dr. Santos offers her Top Ten Insights.

Dr. Santos's presentation received rave reviews at the Symposium. Her presentation, including a question and answer session, is available on the ACTEC website for Fellows until September 8, 2021. It is located on the ACTEC website at Home>CLE>Webinars>Symposium: Happiness and the Good Life.

15. Tip #1: Happiness is Still Important in Challenging Times

A misconception is that happiness depends on our circumstances, but research shows that our happiness levels are predictors of our circumstances.

a. **Economic Results.** Financial success is not just based on one's resumé, but happy people are more likely to get a good job and do well from an economic standpoint. One study measured the cheerfulness levels of 18-year-olds and analyzed their job performance levels a decade later. Those who were more cheerful as 18-year-olds were more likely to have a job and to be doing well in the job and making more money than those who were not cheerful at 18. People perform better if they are in a good mood.

   Another study gave doctors tough medical problems. Half watched a funny video beforehand. The doctors in a better mood and had been laughing did better on the hard medical problems. Being in a better mood helped solve tough problems.

b. **Immune Function.** One study exposed students to a common cold virus. Some were joyful individuals and others were "down-in-the-dumps" people. The low positive style students caught colds at **twice** the rate of high positive style students.

16. Tip #2: Make Time for Nutritious Social Connections

Happy people are more social. Even introverts get benefits from being social. Find time for social connections, and pay attention to what kinds of social interactions make you feel better now.

- Call a friend on the telephone; that will feel nutritious.
- A Zoom happy hour may make you feel better (unless you have been on Zoom calls all day).
- Social media is often not nutritious, and the reader may feel worse afterward.
- If you always leave Instagram feeling badly, stop reading Instagram, or do it less.
- Encourage clients to reach out for social connections.

17. Tip #3: Helping Others Makes Us Happier Than We Expect

Research shows that happy people are others-oriented rather than just thinking about self-care. Even individuals who are forced to do things for others will be happier.

One study handed money to people on the street. They were given either $5 or $25, were told whether to spend the money on themselves or on others and were told that they would be asked at the end of the day about their happiness/mood. The researchers predicted that the individuals who spent the money on themselves would be happier, but in fact those who spent the money on others were happier.

This study has been replicated in various cultures and monetary levels. A similar study was done in Uganda where $20 is a lot of money, for example, enough to buy HIV medication for a week. Those who spent their large amount of money on others were happier than those who spent it on themselves.

Use the little windfalls of extra money or extra time that we have on others.

Clients should be aware of these studies and encourage their children to spend time and money on others for a feeling of well-being.

18. Tip #4: Make Time for Gratitude Every Day

Research shows that "counting your blessings" is not just a platitude; happier people do this even in challenging times. Think of a few things to be thankful for every day.

In one study, individuals were asked to write down 3-5 things every night they were thankful for. After just a few weeks, the participants were significantly happier.

Another study focused on fundraisers at a university. Half of the fundraisers experienced some gratitude from their bosses. The results were shocking; those who experienced the gratitude increased their number of calls by 50%!

Another study by Seligman focused on the longevity of the effect of gratitude on happiness. The study asked participants to deliver a letter expressing gratitude to a person and to read the letter to them. People who received the letters said the effect on them was profound, and the people expressing gratitude were also happier. The bump in happiness lasted from one to three months.

Write a gratitude letter to someone, perhaps a client. Estate planning attorneys may encourage clients who are nearing the end of life to shift toward a sense of gratitude, and that may significantly increase their sense of well-being.

A recent article in the New York Times about writing a gratitude letter, titled "Express Your Love and Appreciation With Words" dated February 28, 2021 mentioned various studies about the positive effects of writing a gratitude letter, finding that "[i]t will make you feel really good and it will make the recipient feel great." The article cites a researcher as saying that a main barrier to writing such a letter is its perceived awkwardness, but empirical research shows that it is actually not awkward at all in practice.

Have pity for people who never express gratitude.

19. Tip #5: Move Your Body to Feel Better

Exercise is important not only for physical health but also for mental health. Research shows that a half hour of cardio every day can do as much to reduce depression as medication. Even just walking a half-hour a day can have significant benefits.

Even if there is no time for the gym, do jumping jacks in your room or some other physical activity.

20. Tip #6: Prioritize Healthy Sleep Hygiene

Individuals should get 7-8 hours of sleep each day. College students say they typically get about 5 hours of sleep a day.

One 1997 study tested subjects with 7.4 hours of sleep per day for two days, only 4.9 hours for seven days, and then normal sleep again for two days. The mood of the subjects tanked during the period of restricted sleep.

Many mental health problems of students could be corrected with adequate sleep. The effects of sleep deprivation are rather dramatic. The effects of only **one** night of sleep deprivation include being more likely to eat more, have an accident, catch a cold, and get emotional. Also the sleep-deprived person is not as approachable, is less focused, and has memory problems, and actually loses brain tissue. Longer term sleep deprivation has serious physical effects including stroke risk, obesity, some cancers, diabetes, heart disease, sperm count decreases, and the increased overall risk of death.

The blue light of a mobile phone provokes wakefulness. Keep the mobile phone away at night.

21. Tip #7: Be Present in the Moment and Savor the Good Things

a. **Mind Wandering.** One study reflected that many people report mind wandering – thinking about things in the past or in the future (such as what I will have for dinner tonight) – to some degree almost 50% of the time.

b. **Two Practical Tips for Staying On Task.** (1) Savoring – For example, if you are eating something delicious, what does this taste like? Smell like? How would I describe it? (2) Meditation – For a period of time pay attention to every breath you take. Every time your mind wanders, yank back to thinking about breaths. Even the simple act of meditating reduces the regions of the brain that causes the mind to wander, not just during meditation but throughout the day.

c. **Be Present in the Moment Even in Sad Present Moments.** "Be present in the moment, even if it feels yucky." The instinct at the time of sad, frustrating, or scary moments is to suppress emotion, but that does not work. One study forced subjects to suppress emotions while watching a sad movie. The conclusion of the study was that suppressed emotions during sad times cause the subject to think worse, and causes cardio stress and negative body changes over time.

   A practical approach for dealing with emotions without suppressing them in sad times is the R.A.I.N process. **R**ecognize the frustration, sad event, etc. **A**llow the feeling to be just as it is. **I**nvestigate what the emotion feels like in your body; maybe it makes you crave to do something while "hanging out" with this emotion. **N**urture with self-compassion. Following the R.A.I.N. process reduces burnout over time (even for first responders in the Covid-19 pandemic).

22. Tip #8: Celebrate Your Successes and Avoid Comparisons

a. **Avid Social Comparisons.** We are prone to engage in social comparisons, even if we are doing well ourselves objectively. Social comparisons can make us feel awful about ourselves or better.

   A study of Olympic winners illustrates the hurdle to happiness by focusing on social comparisons. The silver medal winner my look upset and dejected while the bronze medal winner looks happy. The silver medalist focuses on just missing out on the gold medal, but the bronze medal winner realizes he or she was just milliseconds away from having no medal at all.

b. **Find Success in Things That You Cannot Compare.** Don't focus on my yacht vs. someone else's yacht (or medals, money, trophies, or accolades). Instead, pay attention to things and feelings of fulfillment regarding things that cannot be compared. For example, when Michelle Kwon won a silver medal at the Olympics, she was quite happy on the stand. She was competing not for the medal but for the "roar of the crowd" and the joy of skating over Olympic rings.

   This can be even more important for wealthy clients.

c. **Comparisons With Clients.** Estate planning professionals often represent clients who have much more wealth than the planner. Realize that what you lack in money is made up for in other areas, and those other things are what most impact happiness.

23. Tip #9: Find Purpose by Focusing on Strengths

a. **Money and Happiness; Always Wanting More.** Money is very important to happiness for people who are below the poverty level. For people who are above a poverty level, however, making more money does not necessarily bring more happiness.

One study examined people's perceptions of how much would be needed so that earning more above that would not matter. For people earning $30,000/year, the answer was $50,000 a year. For people earning $100,000/year, the answer was $250,000/year. Two observations are that (1) people would never reach their goals, and (2) as a person earns more money the goal gets farther off. The more you get, the more you believe you need to be happy.

b. **Signature Strengths.** Dr. Martin Seligman, Director of the University of Pennsylvania's Positive Psychology Center, has identified and grouped 24 signature strengths among six different virtues:

Wisdom—curiosity, love of learning, judgment, creativity, and perspective

Courage—honesty, bravery, perseverance, and zest

Humanity—love, kindness, and social intelligence

Justice—fairness, leadership, and teamwork

Transcendence—appreciation of beauty and excellence, gratitude, hope, humor, and spirituality

Temperance—forgiveness, humility, prudence, and self-regulation

Engaging in activities that emphasize signature strengths provides greater job satisfaction and greater productivity, with an overall positive effect.

c. **Job Crafting.** Build signature strengths in crafting job design as much as possible. For example, in one study a subset of janitors thought of their occupation as a calling, taking time to connect with patients, etc.

Clients search for ways they can impact their children's lives. The concept of what is a "good job" is changing to jobs that provide fulfillment and utilize signature strengths.

College students care more now about finding meaning in their lives and enjoying their work. An individual can find meaning in all kinds of jobs; janitors can view their job as a calling and find meaning in what they do.

24. Tip #10: Become Wealthy in Time, Not Money

a. **Time Affluence.** Feeling affluent with time can significantly improve one's happiness. The subjective sense of having free time rather than just the objective amount of free time is important. For example, having a meeting cancel can be a breath of fresh air.

b. **Spend Money to Buy Time.** For example, buying a burger rather than making it can save an hour of time. The more you are prone to spend to get back free time, the more likely you are to be happy.

c. **Time Confetti.** The free time that we have is often in small time chunks, 5 or 10 minutes here and there. We tend to just blow that time, but could use it for things that drive happiness (such as doing jumping jacks, doing a quick meditation, writing in a gratitude journal, etc.) A new book, "Time Smart: How to Reclaim Your Time and Live a Happier Life" by Ashley Whillans (a professor at Harvard Business School) has excellent tips and strategies for becoming time affluent. It suggests having a "time confetti list" of things to do when a spare 5 minutes comes free. Also, you may have a "To Don't" list; a "no" to someone is a "yes" to someone else (or to you).

25. Miscellaneous Happiness Strategies

a. **Forming New Good Happiness Habits.** Take baby steps in forming new habits. For example, don't work on all 10 happiness tips at the same time. Work on the steps that are the hardest for you that will do the most to increase happiness. Do the thing you think is hard, with baby steps.

Steps for forming a new habit include (1) schedule the activity, (2) get social (you are more likely to succeed if you are public about what you are doing or even doing the activity with others), and (3) commit to doing it for a set number of days or weeks at a minimum.

b. **Emotional Contagions.** The concept of an emotional contagion is real. Being with a person who is optimistic rubs off; and vice versa. This is called "affective spirals." We are a link in that spiral and can be a causal link. If we are focusing on these happiness strategies, that can positively affect others.

c. **Animals.** There is considerable evidence that brief interactions with animals is a way to boost one's sense of well-being.

d. **Inherited Happiness? Cultural Differences.** Are some people just hard-wired by inheritance traits to be happier? Research shows that a happiness outlook can be inherited to some degree, but to a much lesser extent than we might think. What is inheritable is the ease with which someone uses these strategies. For example, someone may be more likely to enjoy exercise, to sleep, or to foster social connections.

Similarly, some cultures tend to value some of these behaviors that lead to happiness. The Danish culture emphasizes the types of behaviors described in this summary to foster happiness, and they are always high (if not first) on happiness surveys.

26. Resources

a. **Yale University Course.** Dr. Santos's incredibly popular full course at Yale is available as a free course online! Over 3,300,000 people have taken that class already! To take Dr. Santos' course "The Science of Well-Being": **https://www.coursera.org/learn/the-science-of-well-being**.

b. **Podcasts.** Dr. Santos offers a very wide variety of podcasts through the Happiness Lab, available at **https://www.happinesslab.fm/**.

c. **ACTEC Presentation.** As described above, Dr. Santos's presentation is available on the ACTEC website for Fellows until September 8, 2021. It is located on the ACTEC website at Home>CLE>Webinars>Symposium: Happiness and the Good Life.

Items 27-33 are observations from a seminar by Andrea C. Chomakos, Richard W. Nenno, and Margaret E.W. Sager, From Sea to Shining Sea: Understanding the Landscape of the State Income Taxation of Trusts and Planning to Minimize Tax Exposure

27. Significance and Opportunity

a. **State Income Tax Rates Can Be Very High.** State income tax rates are very high in some states. Examples of the highest top-bracket rate jurisdictions are Oregon (9.9%), New York City (12.696%), and California (13.3%). In 2014 (the last year for which figures are available) 59,685 estates and trusts paid about $342 million of New York income tax; one wonders how much of that could have been saved with proper planning.

b. **No Break for Capital Gains.** Most states have the same rates for capital gains and ordinary income.

c. **Effect of Federal Deduction for State Tax Can Be Minimal.** For federal income tax purposes, a deduction is allowed for the payment of state income taxes. The effect can be minimal, however, particularly for a trust that largely has capital gains.

d. **Grantor Trusts.** Grantor trusts typically are not subject to state fiduciary income taxes, but many trusts are not grantor trusts, and grantor trusts become nongrantor trusts after the grantor's death (or if for some other reason the trust loses its grantor trust status). Furthermore, Pennsylvania does not recognize grantor trusts and other states (*e.g.*, Massachusetts) depart from the federal grantor trust rules.

e. **Governing Law Clauses.** Governing law clauses in trust agreements typically have no effect on determining what state income tax system applies to the trust. (However, they can have an impact in Louisiana, Idaho, and North Dakota.)

f. **Opportunity for Planning.** States typically have clear rules as to what causes the trust to be taxable in the state with factors (that vary among the states) based on the residence of the settlor, trustee, and beneficiaries or where the trust is administered. Some of those factors can be controlled (for example, the trustee can be changed, which could change the residence of the trustee or where the trust is administered). Furthermore, basing state income taxation on the residence of the grantor when the trust was created may be questionable on constitutional grounds under the Due Process or Commerce Clauses.

28. Brief Overview of State Taxation of Trusts and Estates

The one thing that is consistent across the board regarding the state income taxation of trusts is inconsistency. There is a complex labyrinth of separate rules throughout the 50 states and the District of Columbia. Only nine states do not tax the income of trusts (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming). The remaining 42 states (including the District of Columbia) base the taxation of trusts on a variety of factors.

a. **Overview.** The income of grantor trusts is normally taxed to the grantor, distributed ordinary income of a nongrantor trust is generally taxed to the recipient, and source income of the trust (*e.g.*, income attributable to real property, tangible personal property, or business activity) usually is taxed by the state where the property is situated or the activity occurs. Therefore, there are tax savings opportunities for accumulated non-source income of nongrantor trusts, particularly their capital gains.

b. **Grantor Trusts vs. Nongrantor Trusts.** As mentioned above, grantor trusts are typically taxed to the grantor in his or her state of domicile. For nongrantor trusts, most states allow a deduction for distributions, and the undistributed income of trusts is taxed under a complex scheme of varying rules.

c. **Distributed Income.** Income that is distributed from nongrantor trusts is taxed to the beneficiaries under the state income tax laws of where the beneficiaries are located**.** This can result in higher or lower state taxes, depending on how the state taxes trusts and depending on the individual tax rates in the state in which the beneficiary resides.

d. **Nonsource Undistributed Income of Nongrantor Trusts.** The remaining income of nongrantor trusts is generally taxed under the state income tax laws where the trust is deemed to be a resident—and a wide pattern of residency rules have developed over the years to determine whether a trust is a resident trust or nonresident trust as to a particular state. Relevant factors (that vary among the states) are the residence of the settlor, trustee, and beneficiaries or where the trust is administered.

29. Resident v. Nonresident Trusts

Most of the states typically follow one of several patterns to determine whether a trust is a resident trust for that state. Some states do not specifically define a resident trust. Some states look at various factors in determining whether a trust is a resident trust. In some states, any of several factors will be enough to trigger state taxation, and in other states, a trust must meet a combination of factors to impose state taxation. The state statutes vary in their details, and potentially relevant state statutes must be analyzed in detail.

Dick Nenno's written materials include an exhaustive Appendix listing the relevant state statutes in all states and summarizing the factors used in each state.

a. **Overview.** All of the 42 taxing states including the District of Columbia tax a trust as a "resident trust" on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by a resident trustor (for an inter vivos trust), (3) if the trust is administered in the state, (4) if the trust has a resident fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors). A trust included in one of the first two categories is sometimes referred to as a "founder state trust" (i.e., the trust is a resident trust if the founder of the trust was a resident of the state).

b. **Residency of Decedent Creating Testamentary Trust.** Sixteen states tax a trust solely because the testator lived in the state at death. (Therefore, if a decedent dies in one of those states, any testamentary trusts created by that decedent are forever taxed by that state.) Other states include the residence of the testator as a factor, in connection with other factors. For example, in New York a testamentary trust created by a New York decedent is a "resident trust" but an exemption treats some resident trusts as "exempt resident trusts" that are not subject to taxation in New York.

c. **Residence of Settlor of Inter Vivos Trust.** Twelve states tax trusts solely because the settlor lived in the state when the trust was created. Some other states consider the residence of the settlor in connection with other factors. Courts in various states have reached varying results as to the constitutionality of these statutes. States that base taxation solely on the residence of the settlor when the trust was created are particularly suspect on constitutional grounds (see Item 30 below).

For residents of the states that base their taxation of trusts solely on the residency of the grantor, state income taxation is still an important issue in the selection of trustee process. If the instrument appoints a trustee from a state that taxes on the basis of administration or trustee residency, issues of dual taxation and multi-state credits arise.

d. **New York Example.** New York has a grantor/testator-resident statute for taxing trusts, treating as a "Resident Trust" any trust of which the testator was a New York resident on the date of death or was a New York resident on the date the inter vivos trust became irrevocable (or when the revocable trust was created if the trust is still revocable). N.Y. TAX LAW §605(b)(3)(B)-(C). Even so, following the *Mercantile-Safe Deposit* and *Taylor v. State Tax Commissioner* cases, the New York Tax Commissioner issued regulations making clear that New York will not tax a trust that has no New York trustees, no New York sitused assets, and no New York source income. N.Y. COMP. CODES R. & REGS. TIT. 20 § 105.23(c). This exemption was subsequently codified. N.Y. TAX LAW § 605(b)(3)(D)(i). A Resident Trust that is exempt from taxation under these exceptions is referred to as an Exempt Resident Trust. Accordingly, the selection of trustee for a trust created by a New York resident is a critical factor for determining if the New York income tax will apply to undistributed income from the trust. For example, if a Delaware bank is named as trustee and trust assets are located in Delaware, the undistributed trust income would not be taxed in New York or Delaware. (If the grantor wants a New York resident to control investments, consider creating a partnership and naming the New York resident as the general partner of the partnership and contribute the partnership interest to the trust with the Delaware trustee, but query whether New York might try to tax the trust on the theory that the general partner, who is a New York, resident is acting as a fiduciary?) This New York approach is mentioned because this approach is also relevant in almost half the states.

The 2014-2015 New York budget bill made two substantive changes to how New York taxes income. First, New York residents must pay an accumulations distribution tax (which does not include capital gains) when an Exempt Resident Trust later makes distributions to New York residents, and imposes reporting requirements on the trustees of Exempt Resident Trusts. Second, the bill classifies incomplete nongrantor trusts as grantor trusts for New York and New York City income tax purposes

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

California imposes a similar throwback tax. The New York State Bar Association Tax Section had requested that the throwback tax be delayed because of technical problems with the proposal and difficulties of incorporating the federal rules by reference. *See Throwback Tax in New York Budget Plan Raise Concerns, NYSBA Tax Section Says*, BLOOMBERG DAILY TAX REPORT (March 11, 2014).

Incomplete Gift Nongrantor Trusts. "Incomplete gift nongrantor trusts" are trusts formed in a state with no income tax (often Delaware or Nevada, in which event they are referred to as "DING" or "NING" trusts) for the benefit of the grantor and other persons. The purpose of the trust is typically to accumulate income in the trust that is not subject to state income taxation in the state where the trust is located and not included in the grantor's income for state income tax purposes. See Item 32 below. Under the new legislation, such trusts created by New York residents are deemed to be "grantor trusts" for New York income tax purposes, which results in the income being included in the New York grantor's income whether or not the income is distributed to the grantor. This provision is effective for income earned on or after January 1, 2014, but not for trusts that were liquidated before June 1, 2014.

e. **Administration in the State.** Twelve states impose tax on the basis of administration in the state. Six other states apply this factor in combination with other factors. Accordingly, appointing a trustee who would be conducting a significant part of the administration in one of those states would subject the trust to income taxation in that state.

Of the states that impose tax on this basis, only Oregon offers guidance as to what constitutes administration within the state. The other states offer no such guidance.

What if the trust has co-trustees and only one co-trustee is in the state?

f. **Residency of Trustee.** Four states impose tax on the basis of the domicile of the trustee (or any co-trustee). Additional states impose tax on this basis when combined with other factors. If co-trustees are located in multiple states, the income may be pro-rated. For example, this is the approach in California. CAL. REV. & TAX CODE § 17743. Obviously, this is a very important fact to consider before appointing a trustee who is a resident of one of these states.

g. **Residency of Beneficiary.** Only four states impose tax on this basis (California, Georgia, North Carolina, and Tennessee). Two other states use this factor when combined with other connections.

An example of a state that taxes on this basis is California. For example, if no trustee is a resident of California, the trust is taxed on California source income and that portion of non-source income that is to be distributed to resident noncontingent beneficiaries. CAL. REV. & TAX CODE § 17744. Various other states have similar provisions. While not typically done by fiduciaries, trustees might inquire annually specifically about the residence of all beneficiaries, in case a beneficiary moves to a state that uses this factor, causing the trust to owe income tax in that state.

30. Constitutional Issues

a. **Pre-*Quill* (1992) History*.*** Three older U.S. Supreme Court cases (all before 1947) have addressed constitutional issues of state taxation. *Safe Deposit and Trust Company v. Virginia* held that the Due Process Clause prohibits state taxation of a trust based on the residence of beneficiaries. *Guaranty Trust Co. v. Virginia* held that Virginia could tax resident beneficiaries on distributions they received from a nonresident trust. *Greenough v. Tax Assessors of Newport* held that the Due Process Clause did not prevent the city of Newport from imposing a personal property tax on a resident trustee of an otherwise nonresident trust.

Eight state cases addressed the state taxation of trusts in the intervening years before the U.S. Supreme Court again spoke on the issue in 1992.

b. ***Quill* (1992).** The U.S. Supreme Court next spoke on the general issue in 1992, *Quill Corporation v. North Dakota. Quill* had nothing to do with the income taxation of trusts. It involved North Dakota's attempt to collect use tax on catalog sales to North Dakota residents. The case held that the Due Process Clause minimum contacts test no longer required that a business have a physical presence in the state whereas the Commerce Clause substantial nexus test continued to require such a presence. Prior to *Quill*, the cases had focused on the Due Process Clause. Following *Quill*, cases also focus on the Commerce Clause. *Quill* has influenced state income tax cases that have been decided since 1992.

c. **State Cases (1992-2019).** State cases in 1997 and 1999 upheld state trust taxation against constitutional attacks under the Due Process and Commerce Clauses. A variety of state cases beginning in 2013 have suggested a shifting trend when state courts address the constitutional issue. Four state cases in 2013 found that Illinois, New Jersey, and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created and allowed a North Carolina case regarding this issue to continue by rejecting the state's motion for summary judgment. Several of these cases were affirmed by appellate courts in 2015.

For a more detailed summary and listing of the various state cases, beginning in 1992, see Item 31.a-d of ACTEC 2018 Summer Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

d. **Supreme Court-Credits for State and County Taxes From Other States.** In *Comptroller of the Treasury of Maryland v. Wynne,* 575 U.S. 542 (2015), Maryland residents had taxable income from an S corporation that was sourced in several other states. They paid taxes to those states and sought a credit for the taxes paid against their Maryland state and county income taxes. They received a credit against their state income tax, but not the county level tax. This Supreme Court affirmed the Maryland Court of Appeals finding that the failure to provide the credit at the county level unconstitutionally discriminated against interstate commerce. The failure to provide the credit violates the dormant Commerce Clause by burdening out-of-state business with double taxation.

e. **U.S. Supreme Court Weighs In, *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*.** In a 9-0 decision, the U.S. Supreme Court upheld lower court findings that the taxation of undistributed income from a trust by North Carolina solely on the basis of the beneficiaries' residence in North Carolina violated the Due Process Clause, but the Court emphasized that its ruling was based on the specific facts of the case for the specific tax years in question.

The first paragraph of the opinion is an excellent synopsis of the case and the Court's holding.

> This case is about the limits of a State's power to tax a trust. North Carolina imposes a tax on any trust income that "is for the benefit of" a North Carolina resident. N. C. Gen. Stat. Ann. §105–160.2 (2017). The North Carolina courts interpret this law to mean that a trust owes income tax to North Carolina whenever the trust's beneficiaries live in the State, even if—as is the case here—those beneficiaries received no income from the trust in the relevant tax year, had no right to demand income from the trust in that year, and could not count on ever receiving income from the trust. The North Carolina courts held the tax to be unconstitutional when assessed in such a case because the State lacks the minimum connection with the object of its tax that the Constitution requires. We agree and affirm. As applied in these circumstances, the State's tax violates the Due Process Clause of the Fourteenth Amendment.

North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust, 588 U.S. __ (2019)(Justice Sotomayor), concurring opinion (Justice Alito, joined by Chief Justice Roberts and Justice Gorsuch), *aff'g Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 814 S.E.2d 43 (N.C. June 8, 2018), *aff'g* 789 S.E.2d 645 (N.C. App. 2016), *aff'g*, 12 CVS 8740 (N.C. 2015).

The decision is narrow in the sense that North Carolina may be unique in looking solely to the residency of a beneficiary, including a beneficiary whose interest is "contingent," but the opinion does respect the fundamental character of trusts and recognizes the distinct interests and functions of the settlor, trustee, and beneficiaries. In addition the opinion implies that the Court's recent opinion in *South Dakota v. Wayfair, Inc.* 585 U.S. __ (2018), will not have a major impact on the analysis of the constitutionality of state taxation of trusts. While the trend of cases over the last four years has been to find state taxation of trusts on various grounds to be unconstitutional (with most of those cases addressing systems that are based on the residency of the settlor of the trust), the Court goes out of its way to make clear that it is not addressing any of the other regimes for state taxation of trusts. The opinion provides minimal guidance as to the constitutionality of those various systems (or the North Carolina beneficiary-based system under other facts), but reiterates and applies traditional concepts that due process concerns the "fundamental fairness" of government activity and requires “minimum contacts” under a flexible inquiry focusing on the reasonableness of the government’s action.

For a more detailed analysis of the *Kaestner* opinion and planning alternatives in light of the opinion, see Kaestner Trust – Supreme Court Guidance for State Trust Income Taxation found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

f. **Summary of Constitutional Issues.** To uphold state trust income taxation against a constitutional attack under the Due Process Clause, the taxing state must prove:

- The trustee has some definite link, some minimum connection, with the taxing state and income attributed to the state must be rationally related to values connected with the taxing state;
- Physical presence in the taxing state is not required; and
- Whether nonstatutory connections must be considered is unsettled.

To uphold state trust income taxation against a constitutional attack under the Dormant Commerce Clause, the taxing state must prove:

- The trustee has a substantial nexus with the taxing state (physical presence is not required);
- The tax must be fairly apportioned, being internally and externally consistent;
- The tax must be fairly related to services provided by the taxing state; and
- The tax must not discriminate against interstate commerce.

31. Multi-State Taxation; Example

a. **Risk of Multi-State Taxation.** The various states define “resident trust” in different ways, leading to inconsistent income tax treatment, and sometimes resulting in double (or more) state income taxes imposed on the same income. If two different states impose income tax on the same trust, most states (but not all!) allow some form of credit to the extent that other states impose an income tax on the same trust income (but the form of the credit varies dramatically).

b. **Example.** Consider a situation in which the grantor, a resident of California, created an irrevocable trust for his descendants, who reside in California, New York, and New Jersey. The trustees are resident in California and Oregon. The trustees are subject to the investment direction of a committee, composed of individuals residing in California, Delaware, New York, and New Jersey.

The trust is subject to taxation in multiple states: Oregon (100% of the trust income because Oregon bases taxation on having a resident fiduciary or administration in Oregon with no apportionment of the tax among states) and California (83% of the income, because two of six fiduciaries are in California and noncontingent beneficiaries are in California).

A change in the residence of the trustees and change of administration from Oregon and California to Pennsylvania and New Jersey should reduce the overall state taxation of the trust, eliminating taxation in Oregon and reducing exposure in California (to 33.33% of income).

32. ING Trusts

a. **General Description.** The Delaware Incomplete Gift Nongrantor (“DING”) Trust may be used to avoid state income tax. A grantor may be able to create a nongrantor trust in a state with no state income tax that includes the grantor as a discretionary beneficiary and that would avoid state income taxes on undistributed income. (Such trusts created in Delaware or Nevada are referred to as “DING” or “NING” trusts.) This type of trust may be successful in sheltering investment income of the grantor that would otherwise be taxable to the grantor in the state of the grantor’s residence.

b. **No-Rule List, ING Trusts.** The no-ruling revenue procedure for 2020 includes, as one of the items for which rulings or determination letters will not be issued, certain trusts that are typically structured to be non-grantor trusts as an alternative for saving state income taxes. Rev. Proc. 2020-3, §3.01(93).

The Revenue Procedure says that rulings regarding the taxation of the trust under §671 (i.e., whether or not it is a grantor trust) will not be issued for such trusts that are structured to authorize distributions –

> (A) at the direction of a committee if (1) a majority or unanimous agreement of the committee over trust distributions is not required, (2) the committee consists of fewer than two persons other than a grantor and a grantor's spouse, or (3) all of the committee members are not beneficiaries (or guardians of beneficiaries) to whom all or a portion of the income and principal can be distributed at the direction of the committee, or
>
> (B) at the direction of, or with the consent of, an adverse party or parties, whether named or unnamed under the trust document (unless distributions are at the direction of a committee that is not described in paragraph (A)).

Accordingly, DING and NING transactions would presumably be structured in the future to avoid the "bad facts" listed. *See* William Lipkind & Tammy Meyer, *Revenue Procedure 2020-3 – IRS Will Not Rule on Certain Provisions of Non-Grantor Trusts*, LEIMBERG INC. TAX PL. NEWSLETTERS #190 (Feb. 4, 2020).

The 2021 Revenue Procedure deleted that provision regarding taxation under §671 in the "no rulings" section, but added various other provisions in the "areas under study in which rulings will not be issued" section making clear that ING rulings will not be issued regarding the effects under §§671, 678, 2041 and 2514 (powers of appointment), or 2511 (incomplete gift). Rev. Proc. 2021-3, §5.01(9), (10), (15) & (17).

Various IRS rulings over the last several years have approved ING trusts. *E.g.,* Letter Rulings 202006002-006 (community property in ING trust remains community property at first spouse's death for basis adjustment purposes; no ruling whether trust is grantor trust under §675 because that involves fact issues at death), 201925005-201925010, 201908002-201908008, 201852014, 201852009, 201850001-201850006, 201848009, 201848002, 201832005-201832009, 201744006-008. For a detailed analysis of the various tax effects of ING trusts and the shifting positions of the IRS in private letter rulings regarding varying structures of INGs, see Grayson M.P. McCouch, *Adversity, Inconsistency, and the Incomplete Nongrantor Trust*, 39 VA. TAX REV. 419 (2020).

The effectiveness of ING trusts to avoid state income taxes has been removed by legislation in New York (see Item 29.d above), and a proposal is pending in California to do the same. *See* Eric R. Bardell, *California Admits Incomplete Gift Non-Grantor Trusts Work … For Now*, BLOOMBERG LAW NEWS (December 4, 2020).

33. Fiduciary Concerns

Section 108(b) of the Uniform Trust Code (which has been enacted in 24 of the 31 states that have the Uniform Trust Code) says the trustee has a duty to administer the trust in an appropriate place. Therefore, the trustee arguably has a duty to minimize state income tax. Some cases (including a Missouri case) have allowed beneficiaries to force a trustee to change the trust's situs under §§108 and 111 of the Uniform Trust Code. (Because of the difficulty, if not impossibility, of continually monitoring the laws of all of the state and city jurisdictions in the country, some attorneys affirmatively negate the §108(b) duty in drafting trust agreements.)

Similarly, can an attorney be held liable if the attorney does not advise the trustee to move the trust situs to save state income tax, or to consider dividing the trust so at least some of the trust is not subject to state income tax? (For example, if a noncontingent beneficiary is in California, the trust might be divided so that the California person is not a beneficiary of one of the divided trusts.)

Items 34-47 are observations from a seminar by David Arthur Diamond, Nancy C. Hughes, and Margaret G. Lodise, Introducing Trust Protectors: What's Puzzling You is the Nature of Their Game

34. General Description; Overview of Reasons for Using Trust Protectors

Offshore trusts have historically used trust protectors, leading to growing use in the United States. A "trust protector" may be given "grantor-like" powers that can be very limited or very broad to make changes regarding the trust. The trust protector is a third party (not the settlor, trustee, or a beneficiary) who is given powers in the trust instrument designed to assist in carrying out the settlor's intent. A wide variety of powers is possible—but the powers must be specifically described and granted in the trust instrument.

Trust protectors do not have the general responsibility of "protecting" the trust—the "trust protector" term is simply the terminology used historically.

A trust protector may be given the authority to take "settlor-type" actions that the settlor cannot retain directly for tax reasons. A trust protector can be a safety valve for "fixing" old (or new) trusts. A trust modification or decanting could accomplish the same goal, but a trust protector can take these actions without involving courts, beneficiaries, or even the trustee.

35. Historical Uses of Trust Protectors

The concept of trust protectors has been used historically, but without that name. Examples include holders of limited powers of appointment, trustee appointers, investment advisors, and distribution advisors. Trustees have been given the authority to amend charitable trusts or to modify trusts so that they can hold S corporation stock. Persons have been given the power to remove and appoint trustees.

36. Trust Protector Statutory Authority

Section 808 of the Uniform Trust Code is entitled "Powers to Direct." Section 808(d) provides that "a person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interest of the beneficiaries." Comments to §808 provide that the section ratifies the "use of trust protectors and advisers." It explains that "Advisers" have been used for certain trustee functions and distinguishes trust protectors:

> "Trust protector," a term largely associated with offshore trust practice, is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust. Subsection (c) ratifies the recent trust to grant third person such broader powers.

The Comments have no further discussion specifically about trust protectors.

The Uniform Trust Code has been adopted in a majority of states; some of them adopted §808 verbatim and others made slight changes. Some states also have separate statutes governing trust advisors and trust protectors, or sometimes just trust protectors.

The authority and specific powers held by a trust protector are as described in the trust instrument, but statutes developed in various states in recent years provide clarity regarding the role or actions of trust protectors. A variety of the state directed trust statutes have language broad enough to apply to trust protectors as well. *E.g.,* 12 DEL. C. §3313(f) ("For purposes of this section, the term 'advisor' shall include a 'protector'"; a non-exclusive list of sample powers includes removing and appointing fiduciaries, modifying or amending the instrument for tax or other efficiency reasons, and modifying powers of appointment). Some states have enacted statutes addressing the powers of trust protectors specifically (including, among various others, Alaska, Delaware, Idaho, Illinois, Nevada, New Hampshire, South Dakota, Tennessee, and Wyoming) that list sample powers that trust protectors could hold. *E.g.,* 760 ILL. COMP. STAT. §16.3(d) (non-exclusive list of 10 sample powers that trust protectors could hold); NEV. REV. STAT. §163.5553 (non-exclusive list of 12 sample powers that trust protectors could hold).

Almost all of the state statutes are default statutes—providing a list of possible powers but stating specifically it is not an exclusive list. Most of the statutes make clear that trust protectors only have powers that are specifically granted in the trust instrument.

37. Special Power of Appointment – "Poor Person's Decanting Power"

A non-fiduciary limited power of appointment to distribute property outright or in trust for a limited class of individuals is a brief and simple way of providing a way to "fix" problems with trusts in light of changing circumstances. The trust might give an individual (usually a family member) a non-fiduciary power of appointment to redirect who will receive assets, to change the division of assets among beneficiaries, to change the trust terms, etc.

Many years later the settlor's children may be in a better position than the settlor to decide how the assets should be used for their respective children. "A fool on the spot is worth a genius two generations ago." Also, the power of appointment is a "power of disappointment," giving the powerholder a "stick" over other disgruntled and disruptive beneficiaries.

An advantage of a non-fiduciary power of appointment is that persons exercising the power of appointment typically have no liability for the manner in which the power is exercised, even if the exercise disinherits a beneficiary.

An example from Nancy Hughes (adapted from a provision by Louis Harrison, included with Nancy's permission) is as follows:

> Power of Appointment by Special Power Holder. During my life, the trustee shall distribute the principal to any one or more of my spouse, my descendants, and the spouses of my descendants, or trusts for any of them, as the special power holder from time to time appoints during his or her life; provided that any such trust does not extend beyond the period permitted by any applicable rule of law relating to perpetuities. I name as the special power holder the following in the order named who is from time to time willing and able to act:
>
> (a) my friend and attorney, I. M. Ntrouble
>
> (b) my friend and accountant, Hert N. Meee.

The class could be expanded to include "descendants of the grantor's parents" to be extremely broad.

Be aware that granting someone an inter vivos limited power of appointment will likely result in the trust being a grantor trust (assuming its exercise is not subject to the approval of an adverse party). §§674(a), 674(b)(3) (exception for testamentary powers of appointment but not inter vivos powers of appointment).

38. Common Powers of a Trust Protector

Trust protector powers related to the trustee may include the power to remove and replace trustees, to appoint additional trustees, to act as a tiebreaker, to provide advice or direction regarding discretionary distributions or regarding management actions, or to veto trustee decisions. Powers unrelated to the trustee include the power to change the trust situs or governing law, to terminate the trust under specified conditions, to amend the trust for any valid purpose such as to respond to changes in tax laws, or to alter the beneficial interests such as adding or removing beneficiaries.

39. Sample Clause with Expansive Trust Protector Provisions

The following is an example of expansive trust protector powers from Nancy Hughes (included with her permission). She emphasizes that these should not be included as boilerplate provisions, but each power should be carefully considered in light of the worst-case situation of an abusive trust protector.

> ARTICLE 1
>
> <u>Trust Protector</u>
>
> (a) Designation. I. M. Ntrouble shall be the initial Trust Protector. During my lifetime, [third party] may appoint any one or more qualified corporations, or any one or more individuals other than a Disqualified Person as to me, as the Trust Protector, Co-Trust Protector, or successor Trust Protector of this trust or any separate trust created hereunder, to act with or to succeed the then acting Trust Protector consecutively or concurrently, in any stated combination, and on any stated contingency; provided that any such designation may be amended or revoked before the designee accepts office. The powers retained in this paragraph may be exercised by a signed instrument filed with the trust records, and any later instrument shall take precedence over an earlier instrument.

(b) Powers of Trust Protector. The Trust Protector is not a fiduciary and as such, owes no fiduciary duty to the beneficiaries. The Trust Protector may exercise the following powers, in the sole discretion of the Trust Protector and upon such exercise, the Trustee shall follow the directions of the Trust Protector:

(i) To remove any then serving or appointed successor trustee without cause.

(ii) To appoint successor trustees or co-trustees.

(iii) To determine, upon the request of the Trustee, what constitutes reasonable compensation to the Trustee.

(iv) To change the situs of the trust.

(v) To change the governing law of the trust.

(vi) To modify the trust and represent the interests of all beneficiaries of the trust, current, presumptive remainder, and contingent remainder.

(vii) To decant the trust to a new trust.

(viii) To terminate the trust, in which case, the Trustee shall distribute the assets to the then current beneficiaries.

(ix) To direct the sale of [closely held asset] upon such price and terms as the Trust Protector determines.

(x) To approve the concentration of [___%] of the trust investments in a single investment.

(xi) To direct the distribution of [___%] of the trust assets to the current beneficiaries.

(xii) To consolidate any trust held under this instrument with any other trust if the beneficiaries of the trusts are the same and the terms of the trusts are substantially similar.

(xiii) To divide a trust into two or more separate trusts or to segregate an addition to a trust as a separate trust.

(xiv) To resign at any time by signed notice to the Trustee.

(c) Release of Powers by Trust Protector. The Trust Protector at any time acting may, by written instrument delivered to the Trustee, irrevocably release any of the powers granted to the Trust Protector under this Article. If the Trust Protector irrevocably releases a power, such power shall thereafter no longer be exercisable by the Trust Protector or any successor Trust Protector.

(d) Compensation of Trust Protector. The Trust Protector shall be paid reasonable compensation from time to time for his/her services as Trust Protector.

(e) Exoneration of Trust Protector. The Trust Protector shall not be liable to any current or remainder beneficiaries unless the Trust Protector acts with reckless indifference to the trust purposes.

(f) Exoneration of Trustee. The Trustee shall not be liable for following the directions of the Trust Protector unless the directions are manifestly contrary to the terms of the trust.

Disqualified Person. The term "Disqualified Person" hereunder shall mean me, any person who has contributed property to such trust, any beneficiary of such trust, the spouse of any beneficiary of such trust, and any individual or entity who would be considered a "related or subordinate party" under Code Section 672(c) as to any of the foregoing such persons, had such person been the grantor of such trust (including without limitation such person's spouse, father, mother, issue, brother, sister, or employee; a corporation in which the stock holdings of such person and the trust are significant from the viewpoint of voting control, and any employee of such corporation; and a subordinate employee of a corporation in which such person is an executive).

40. Who to Name?

The trust protector must be someone the grantor "really really" trusts. A problem with appointing a trust protector is deciding who should serve in that role. The trustee is the most "trusted" person from the settlor's point of view. Who can override that? The settlor needs "an even smarter and even more trusted person" to override the trust with the trust protector powers.

Persons that panelists have seen used as a trust protector include a college roommate, CFO of a closely held company, CPA, non-estate planning lawyer, and close personal friend.

A concern is finding someone willing to serve, particularly if the protector acts in a fiduciary capacity considering potential liability for making broad changes to the trust.

The trustee should not also be named as a trust protector, acting in a nonfiduciary capacity, as to some issues. How does that person balance interests to exercise powers held as a nonfiduciary without also considering her fiduciary duty to beneficiaries?

Another alternative may be to name an entity as the trust protector. That may be a way for providing for succession of the protector. If an entity is used for liability protection, a thinly-funded LLC that has no economic substance might provide little protection; courts may look to the officers and directors for liability.

If an appropriate trust protector cannot be identified when the trust instrument is signed, consider providing for the role of a trust protector in the trust instrument, but stating that it will be filled at a later date by the grantor, grantor's spouse, adult beneficiaries, or other appropriate parties.

41. Should the Trust Protector be a Fiduciary?

Statutes sometime address whether a trust protector acts in a fiduciary capacity. Most of the statutes addressing trust protectors provide that they are considered to act as a fiduciary unless the trust instrument provides otherwise (Delaware is an example of that approach). Taking the opposite approach, the South Dakota and Alaska statues provide that the trust protector is not a fiduciary unless the trust instrument provides otherwise. The Wyoming statute provides that trust protectors "are fiduciaries" to the extent of the powers, duties, and discretions granted to them in the trust instrument.

In light of the variety in state law regarding whether protectors act as fiduciaries, the trust instrument should specify explicitly whether the protector acts in a fiduciary capacity.

If the trust protector has the power to direct the trustee to take specified actions, the protector should act in a fiduciary capacity as to such powers.

a. **Trust Advisor vs. Trust Protector.** Some authorities distinguish trust advisors and trust protectors as having very different functions. Trust advisors have powers that are subsumed within the power of the trustee—they hold powers in a fiduciary capacity. Trust protectors are not fiduciaries, and they only have powers specifically granted to them in the trust instrument.

b. **Trust Directors.** Directed trust statutes address situations in which a third party has the power to direct the trustee to take certain actions. The general consensus is that directors, who are directing trustees to take actions, should act in a fiduciary capacity. Someone should be responsible in a fiduciary capacity for all trustee actions, and the trustee will want to know that the person directing the trustee to take action acts as a fiduciary. Directed trust statutes typically provide that a trustee has no liability for any loss caused by following the direction absent "willful misconduct" on the part of the trustee (or some other standard in a particular state statute). If the trustee is not liable for any loss, and if the party directing the trustee is not a fiduciary, where does the responsibility to the beneficiary lie?

c. **Advise vs. Direction.** Go for clarity. The trust instrument should make crystal clear whether the trustee is *directed* to follow certain types of directions, or whether the third party is merely *advising* the trustee but the decision is still up to the trustee's discretion. If the protector is acting in an advisory role, a Reporter's Note from the Restatement (Third) of Trusts §75 suggests that the trustee has a duty to consult with the protector before the trustee acts. Consider setting a dollar amount or percentage floor before the consultation requirement applies so the trustee may make day-to-day decisions without consulting the protector.

   One panelist concludes "the court will want to find someone to make responsible (and liable). If you give the protector powers that look like trustee powers, courts will hold them liable as a fiduciary."

d. **Delineating Particular Powers That Are Exercised in a Fiduciary Capacity.** Whether a trust protector's authority is exercised as a fiduciary may likely depend on the type of action involved.

   Some powers must be exercised in a nonfiduciary capacity for tax reasons. For example, a substitution power must be exercised in a nonfiduciary capacity in order to be a grantor trust trigger.

A power of a trust protector to terminate the substitution power or any other power that causes the trust to be a grantor trust might also be exercised in a nonfiduciary capacity.

Some powers presumably could not be exercised in a fiduciary capacity, such as the power to add or exclude a beneficiary of a trust or changing the beneficial interests of beneficiaries. Exercising those types of power requires taking into account considerations other than just the interests of the current beneficiaries.

Powers that do not change the beneficial interests of beneficiaries could be specified in the trust instrument as being held in either a fiduciary or nonfiduciary capacity.

e. **Impact on Potential Liability of the Protector.** A protector acting as a fiduciary will be held to a higher standard than a nonfiduciary. Indeed, a third person may be less willing to agree to act as trust protector if the person acts as a fiduciary. The planner might consider the settlor's intent as to potential liability of the protector in determining whether to specify that the protector acts as a fiduciary. Settlors will typically want to minimize the risk for trust protectors.

Even if the protector acts as a fiduciary, a very broad exculpatory provision could be included (to the extent allowed under state law). But whether the exculpatory clause will actually result in protecting the fiduciary will always be subject to some degree of uncertainty.

Panelists had varying views about this issue. Some would generally provide that trust protectors are not fiduciaries in order to reduce the risk to them. Others would generally provide that protectors are fiduciaries and rely on exoneration in a trust instrument to exonerate the protector from liability except in the case of willful misconduct. One panelist advises that a protector should particularly be careful with holding a fiduciary power to direct the trustee regarding investments and investment concentrations, even with broad exoneration in the trust instrument.

f. **Standard for Protector Liability.** In any event the trust protector's standard of liability should be clearly stated in the trust agreement to avoid uncertainty.

42. Succession of Trust Protector Position

For very long-term trusts, having a procedure for appointing successor trust protectors is very important.

43. Insurance for Trust Protectors

Insurance coverage is generally only for fiduciaries, but one panelist thinks insurance coverage for trust protectors acting in a nonfiduciary capacity is available. It is a cottage industry, and we will be seeing more of it.

44. Compensation

Compensation should generally be provided for the trust protector, even if not acting in a fiduciary capacity. If the drafting attorney also serves as a trust protector with compensation, ethical duties may require that the client have independent advice as to that issue.

45. Potential Tax Attacks If Facts Reflect That Settlor Retains Tax-Sensitive Powers Indirectly Through Actions of a Trust Protector

Long ago, the IRS tried to make a "de facto trustee" argument, treating a settlor as holding the powers of the trustee if the settlor exercised persuasive control over the trustee. Courts (including a U.S. Supreme Court case) rejected that "de facto trustee" argument. However, *SEC v. Wyly* raises concerns for estate planning advisors by treating settlors as the de facto trustee of a trust (albeit in an extreme fact situation in which the trustees always followed the settlors' directions for over a decade).

SEC v. Wyly, 2014 WL 4792229 (S.D.N.Y. September 25, 2014) (Judge Scheindlin), is the determination of the "disgorgement" remedy in a securities law violation case by the billionaire Wyly brothers. The court based the amount of disgorgement largely on the amount of federal income taxes that the defendants avoided from the use of offshore trusts, after finding that the trusts were grantor trusts and that the defendants should have paid federal income taxes on all of the income from those trusts. The court determined in particular that the "independent trustee" exception in §674(c) did not apply even though the trustees were various Isle of Man professional management companies. Three close associates of the Wylys (the family attorney, the family office CFO, and the CFO of one of the Wyly entities) were trust protectors who had the power to replace the trustees. Throughout the trust administration, the Wylys expressed their requests to the trust protectors, who relayed them to the trustees, who always complied.

There is a growing trend toward naming trust protectors with very broad powers, including the broad ability to amend trusts, change beneficial interests, veto or direct distributions, modify powers of appointment, change trustees, or terminate the trust—all in the name of providing flexibility to address changing circumstances, particularly for long-term trusts. The *Wyly* case points out how that could backfire if a pattern of "string-pulling" by the settlor occurs in practice with respect to the exercise of those very broad powers. Planners will not stop using trust protectors in the future because of *Wyly* but should be aware of potential tax risks that can arise if the broad trust protector powers are abused by overbearing settlors.

46. Case Law Discussion of Trust Protectors

Relatively few cases have addressed trust protectors. Many of the cases that do exist are unreported, so cannot be cited as authority. Many of the cases that have discussed trust protectors have focused on whether the protector in the particular situation was acting as a fiduciary.

a. ***IMO Ronald J. Mount 2012 Irrevocable Dynasty Trust.*** This unreported Delaware case gave effect to the provision in the trust instrument that the trust protector served in a nonfiduciary capacity. *IMO Ronald J. Mount 2012 Irrevocable Dynasty Trust U/A/D December 5, 2012*, (2017 WL 4082886 (not reported in Atl. Rptr.) (Del. Ct. of Chancery 2012). "A settlor's decision to allow the trust protector to serve in a non-fiduciary capacity is valid and will be enforced under Delaware law." The court acknowledged but discounted a citation to a law review article arguing that a trust protector who is given broad powers has fiduciary duties even if the trust instrument says the trust protector is not a fiduciary.

b. ***Robert T. McLean Irrevocable Trust v. Patrick Davis, P.C.*** The attorney for a successful plaintiff in a personal injury lawsuit was named as trust protector of a trust that received the settlement proceeds. He had the power to remove the trustees and appoint successor trustees or trust protectors. When the original trustees resigned, the trust protector designated as successor trustees the attorneys who had referred the personal injury case (as well as other cases) to him. The family alleged that the trustees were wasting trust funds, and sued the trust protector for failing to monitor the actions of the trustee, failing to act when the trustees acted against the interests of the beneficiary, and giving his loyalty to the trustees rather than to the beneficiary. The trust protector sought summary judgment in part because he had no duty to supervise or direct the actions of the trustee. The court of appeals denied summary judgment, reasoning that since the trust agreement granted authority to the trust protector in a fiduciary capacity, the protector owed at least the basic fiduciary duties of undivided loyalty and confidentiality. Also, the limitation of liability in the trust agreement implies the existence of a duty of care and liability for actions taken in bad faith. Following a jury trial, the court granted a directed verdict in favor of the trust protector and the court of appeals affirmed, finding no basis for a breach of duty by the trust protector for various factual reasons.

   The court specifically addressed to whom the trust protector owed duties:

   > An important question of material fact also exists in the instant case as to who this fiduciary duty of good faith is owed to. Appellant assumes it is owed to the Beneficiary, but the trust provision that created the position of Trust Protector does not explicitly indicate who or what is to be protected.… {I]t is possible that the Trust Protector's fiduciary duties are owed to the trust itself.

   McLean v. Davis, 283 S.W.3d 786 (Mo. Ct. App. 2009), *aff'd following remand, Robert T. McLean Irrevocable Trust u/a/d March 31, 1999 ex rel. McLean v. Ponder,* 418 S.W.3d 482 (Mo. Ct. App. 2013).

c. ***Gowdy v. Cook.*** This case initially involved a trust protector, but the case ultimately did not address the protector. One lawyer of a firm was named as trustee and another was named as trust protector. Both were to receive fees in those capacities as well as traditional attorney fees. The trust included an exculpatory provision and a no contest provision. The initial beneficiary complained about conflicts of interest. The trust protector resigned but the trustee did not. The beneficiary sued for malpractice, breach of fiduciary duties, breach of duty of good faith and fair dealing, and negligence. The beneficiary also asked that the trust be decanted into a trust that removed the requirement in the original trust that a corporate trustee be appointed as successor if the beneficiaries removed the trustee. The court found no damages, defeating the claim for malpractice and breaches of duty, and held that the request for the decanting amounted to a violation of the no contest clause, thus disqualifying the beneficiary as a trust beneficiary. *Gowdy v. Cook,* 2020 WY 3, 455 P.3d 1201.

d. ***In re Eleanor Pierce (Marshall) Stevens Living Trust.*** This case, involving J. Howard Marshall, II (of Anna Nicole Smith notoriety), held that trust protectors are not inherently a violation of Louisiana's public policy. The trust instrument authorized a trust protector to remove the trustee, which the trust protector did because of likely breaches of trust by the trustee. The trustee sued, complaining that Louisiana has no statute recognizing trust protectors and that making the trustee answerable to a trust protector violated public policy. The court held that the trust agreement was unambiguous that the protector could remove the trustee and cited a strong policy of supporting settlor intent. *In re Eleanor Pierce (Marshall) Stevens Living Trust*, 159 S.3d 1101 (La. App. 3 Circ. 2015).

e. ***Minassian v. Rachins.*** This case has had various determinations by the courts of appeal (in 2014 and 2018). The drafting lawyer serving as trust protector amended the trust in the middle of litigation between the widow-trustee and the children from a prior marriage over widow's distributions to herself. The amendment favored the widow, and purportedly carried out the settlor's intent to provide his wife with the lifestyle of being fans of horse racing and legal gambling, which they had enjoyed together. The amendment provided that on termination, the assets would pass to subsequent trusts, not directly to the children. The 2014 decision upheld the amendment, and remanded the case. *Minassian v. Rachins*, 152 So. 3d 719 (Fla. 4th DCA 2014). The children filed a new complaint, alleging dissipation of assets by the wife due to a gambling problem and included the trust protector as a defendant. The protector subsequently died, and the proceedings do not discuss any continuing liability by the protector. The court of appeals ultimately determined that, despite the amendment that appeared to accomplish the settlor's intent of protecting the widow's lifestyle, the children had, at a minimum, an equitable interest in any property in the trust. The trust was again remanded for further proceedings. Thus, the trust protector plan appears not to have worked, but the widow has enjoyed the trust's assets for the intervening years and during the continuance of the legal proceedings. *Rachins v. Minassian*, 251 So. 3d 919 (Fla. 4th DCA 2018).

f. ***Carberry v. Kaltschmid.*** The trust agreement named a trust protector with the power to amend or modify the trust, to construe the trust in the event of an ambiguity, and to execute documents to carry out any protector or trustee power. The protector had "no duty to investigate the Trustee's actions or inactions, to audit the trust's books, to review the trust's investments, or to evaluate the trust portfolio's performance." Two children were co-trustees, and one of them sought ex parte approval of a loan and approval to use the loan proceeds without the approval of a co-trustee. The protector sought a court order compelling a trust accounting, directing the trustees to communicate with the protector, and confirming the protector's power to appoint an independent special trustee. The trial court found that the protector lacked standing to demand an accounting and the appellate court agreed. *Carberry v. Kaltschmid*, 2018 WL 2731898 (Ca. 1st Dist. 2018) (unpublished).

g. ***Matter of Trust for the Benefit of Hettrick.*** The trust instrument authorized the trust protector to remove and replace the trustee. The beneficiary of a special needs trust moved to Virginia, and the trust protector wanted to remove the New York trustees and replace them with a Virginia trustee, following approval of New York and Virginia courts of moving the trust situs to Virginia. The New York court refused to approve the removal of the New York trustees even though the court acknowledged that the protector had the power to remove the trustee without cause and nothing in the trust instrument prohibited changing the trust situs. The court noted that "the entire tenor of the Trust provisions of decedent's Will indicate that New York law is to apply." In effect, the court simply ignored the explicit authority of the trust protector under the trust agreement. *Matter of Trust for the*

Benefit of Hettrick, 111 N.Y.S.3d 522, 61 Misc. 3d 1220(A) (Surrogate's Court, NY Erie County Nov. 19, 2018) (unreported).

47. Trust Protector Planning – Best Practices

The following summary of best practices is from a summary of a presentation at the 2015 Heckerling Institute on Estate Planning.

(1) Use a trust protector only if necessary or desirable for particular purposes.

(2) Never rely on state law but spell out in detail what powers are included. Do not just adopt a list of powers that may be included in a state statute because some of those powers are likely not appropriate for a particular situation.

(3) Make clear in the trust instrument that the trust protector acts in a non-fiduciary capacity. If the protector acts in a fiduciary capacity, state very clearly what that means specifically in the context of the powers that the protector has.

(4) Clearly and specifically describe the powers, duties and compensation of the protector.

- State whether the protector has a duty to monitor the trust situation continually or whether the protector is just in a stand-by mode until requested to act or until some event described in the instrument occurs.
- If the protector has a duty to monitor, provide that the protector has the right to receive information from the trustee that is appropriate to the monitoring function.
- Provide for compensation appropriate to the protector's functions.
- Provide for appropriate exoneration of the trustee, the protector, or both with respect to actions taken or not taken by the protector.
- Describe the manner in which the protector's powers are exercised. For example, if a protector has the power to remove and replace trustees, clarify whether the protector must monitor the trustee's performance or just exercise its discretion when requested by a beneficiary.
- Provide that the protector has standing to enforce its powers in a court action.

(5) Use the appropriate name (protector rather than advisor [i.e., one who is carrying out or directing trustee functions as a fiduciary]—assuming that is the intent).

(6) Do not mandate that the protector exercise its power (unless that is the settlor's intent) but provide that the protector may exercise its powers in its sole and absolute discretion and that its decisions will be binding on all persons.

(7) Specify the duty and liability of the protectors—for example that there is no liability absent bad faith or willful misconduct. In providing for the protection of the protector, specify who will pay the protector's attorney fees if the protector is sued.

(8) Clarify whether the protector has the right to receive information from the trustee and what information is intended.

(9) Make clear that the term "protector" is just the name given to the person and that the protector does not have the function of "protecting" the trust generally.

(10) The protector should discuss with the settlor what the settlor intends the protector to do and how to carry out its functions. The trustee should clarify what its role is with the protector in the wings and what information it should provide to the protector and at what times.

Items 48-56 are observations from a seminar by David C. Blickenstaff, Michael M. Gordon, and Michaelle D. Rafferty, Silent Trusts in a Very Loud World: God's Gift? Or the Devil's Work? The following summary also includes observations from other sources about silent trusts.

48. Basis Description; Reasons for Using Silent Trusts

A silent or quiet trust is a trust that relaxes the fundamental duty of a trustee to keep beneficiaries informed and directs the trustee not to inform beneficiaries of its existence, its terms, or information about the trust administration, at least for some specified period of time or until the beneficiaries reach a specified age. These terms are often used interchangeably.

A classic reason for using a silent trust is that the settlor may believe that a beneficiary's knowledge of the existence of the trust could be devasting or at the least de-motivating for the beneficiary. Having vast wealth in trust for a family member who has never experienced having money is very scary for the beneficiary's well-being. Other examples include:

- Intention to take advantage of the window of opportunity for making gifts before the large $10 million (indexed) gift exclusion amount disappears but with no intent of the beneficiary receiving any benefits from the trust for many years (perhaps until after the settlor's death);
- Concern for the safety of high-profile individuals;
- Receiving structured settlements in personal injury actions; and
- Protection of trust assets from a beneficiary's creditor obtaining information about the trust assets (for example, a beneficiary's spouse in a divorce action).

49. Statutory Disclosure Requirements

a. **Uniform Trust Code.** Section 813 of the UTC imposes upon a trustee duties to provide various information to beneficiaries. Certain information must be provided to "qualified beneficiaries" (i.e., current distributees and persons who would be distributees if the trust terminated or if the interest of current distributees terminated, §103(13)) and other information to "beneficiaries" (i.e., persons having a present or future beneficial interest in the trust, either vested or contingent, or holding a power of appointment in a non-trustee capacity, §103(3)). This includes information related to the trust's administration, a copy of the trust instrument, notification of the trustee's acceptance of trusteeship, the existence of the creation of an irrevocable trust (or when a revocable trust has become irrevocable), a change in the trustee's compensation, and trust accountings.

   Section 105(b) provides that the settlor may limit these requirements except for several mandatory duties including (i) to respond to a qualified beneficiary's request for reports and information reasonably related to the trust's administration and (ii) to notify qualified beneficiaries who are age 25 or older of the existence and identity of the trust and of the right to request a trustee's report. The Comment to §105 specifically makes clear that the settlor can waive the duty to provide qualified beneficiaries a copy of the trust instrument or annual reports (unless information requested is reasonably related to the administration of the trust), and can waive the duty to inform qualified beneficiaries under age 25 of the existence of the trust.

   Sections 105(b)(8) and (9) limit the settlor's ability to waive the disclosure requirements. States have varied significantly as to their treatment of these provisions. Some states have deleted subparagraphs (8) and (9) of §105(b) entirely, implying that a settlor may provide that the trust may be kept totally secret. Other states allow the settlor to designate surrogates to receive notice on behalf of certain types of beneficiaries, or allow the settlor to waive the required notice but not the obligation to respond to beneficiary requests for information.

b. **Restatement (Third) of Trusts.** Section 82 of the Restatement (Third) of Trusts imposes various duties on trustees to provide information to beneficiaries. Comments to §82 provide that the settlor can modify the duty to provide information, but not entirely or to a degree (or time) that would unduly interfere with the purposes for the information requirements, and cannot modify the duty to respond to a beneficiary's request for information reasonably necessary to enforce his or her rights and/or prevent a breach of trust.

c. **State Statutes.** Over half of the states have statutes permitting trust instruments to allow for the creation of silent trusts; some of those states have adopted the UTC but have altered the default trustee disclosure requirements. Jurisdictions with statutes altering a trustee's disclosure requirements (or that allow information to be given to a representative) include Alaska, Arizona, Arkansas, Delaware, District of Columbia, Florida, Georgia, Illinois, Kansas, Kentucky, Maine, Michigan, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, and Wyoming. These statutes vary widely, but there is a trend towards allowing a settlor to designate a surrogate to receive information on behalf of the beneficiary. Also, a number of the states require an accounting, either annually or at a trust's termination, regardless of whether or not other trustee duties can be waived.

50. Balancing of Interests

While the settlor may have very altruistic reasons for having silent trust provisions, at least for some period, the settlor should balance those reasons with the potential advantages of being able to provide the beneficiary with information about the trust. The motivation and purpose for prohibiting or limiting disclosure of the trust to beneficiaries is understandable. But informing the children about the trust and using it to educate children about stewardship may be very helpful for the children. Maybe, if children had known about the trust, they would have risked capital in a worthwhile business, or would have become teachers and taken a smaller salary. In addition, children will see the wealth, or they will get a check or a K-1, or they will hear something else about the trust, and then it is awkward if they can't learn everything about the trust, including, sometimes, even the ability to decant or otherwise alter the trust. And such complications are aggravated if the same lawyer represents some or all the children too. But in any event, an age-appropriate limitation might be desirable and fitting, such as limiting the provision of information up to age 30 (as under current Illinois law) or age 25 (as under §105(b)(8) of the Uniform Trust Code). And perhaps parents should be able to waive the limitations on disclosure with respect to their own children.

Fundamentally important, a trust must be enforceable in order to be a trust, and information is often necessary for enforcement. Including provisions for a "designated representative" or surrogate to receive information on behalf of a beneficiary may be a way to balance interests and provide information necessary for enforcement.

51. Drafting Considerations

Issues that should be considered in drafting silent trust provisions include:

- Time period for which information may be withheld; trusts typically provide a particular age at which beneficiaries will receive information, such as 25 or 30; alternatively, the trust could be a quiet trust during the life of the settlor, or perhaps the settlor and the settlor's spouse; many statutes allow silent trust provisions only up to a specified age such as 25 or 30; Delaware provides that information may be withheld for a "period of time" with examples related to the age of a beneficiary, the lifetime or each settlor or spouse of a settlor, a term of years or specific date, or a specific event;
- Types of information that may be withheld (such as notice of the trust's existence, a copy of the trust instrument, an inventory of trust assets, or trust accountings); and
- Provisions for a "designated representative" or surrogate to receive information on behalf of the beneficiary (see Item 55 below).

The following is sample concise language (from a presentation by David Handler at the 2020 Heckerling Institute on Estate Planning) intended to strike a balance:

> Trustee will have no duty to provide notice to beneficiaries other than as provided in this paragraph but Trustee, without liability, may provide notice to beneficiaries beyond that required in this paragraph. Trustee will, within nine months after acquiring knowledge of my incapacity or death, or upon creation of a new trust hereunder,

> notify as Trustee determines at least one current income beneficiary, or person entitled to discretionary distributions of income or principal, age 25 or older: (a) of the existence of the trust; (b) that the trust was created by me; and (c) that the person(s) notified has the right to request a copy of the provisions of the trust agreement that apply to the beneficiary and to request annual or more periodic reports of the trust assets, liabilities, receipts, and disbursements (including the source and amount of Trustee's compensation, a listing of the trust assets and, if reasonable, their respective market values). Trustee providing notice to Trustee will not be sufficient notice under this paragraph unless, at such time, no other beneficiary is entitled to notice under this paragraph. Unless unreasonable under the circumstances, Trustee will respond to written requests for information pertaining to the administration of the trust from any current income beneficiary or person entitled to discretionary distributions of income or principal.

The written materials for the presentation at the 2021 ACTEC Annual Meeting include three sample forms, one of which is a detailed form with provisions regarding the appointment of a designated representative to receive information on behalf of the beneficiary, the scope of the designated representative's responsibility, the effect of inadvertent disclosure, liability of the trustee and the designated representative, indemnification of the designated representative, resignation of the designated representative, and the appointment of successor designated representatives.

52. Practical Issues in Administering Silent Trusts

a. **Crummey Trusts.** Quiet trust provisions obviously do not work with Crummey trusts, under which beneficiaries are typically given a notice of contributions to the trust and their right to withdraw those contributions for a limited period of time. (Amazingly, some trusts have both Crummey trust provisions and quiet trust provisions; they are incompatible.)

b. **Mere Discretion to Withhold Information.** If the instrument merely authorizes but does not direct the trustee to withhold information from beneficiaries, the trustee will often not be willing to exercise that discretion. A preferable approach is to direct the trustee to maintain a quiet trust. Trustees want clear language of when they are to notify beneficiaries and which beneficiaries are to receive notice.

c. **Client Request to Withhold Information if No Quiet Trust Provisions in Document.** If the client requests the trustee not to give information to beneficiaries, but there are not quiet trust provisions in the instrument, the trustee will likely be unable to comply with that request. Some states, such as Alaska, allow quiet trust provisions to be in a free-standing instrument other than the trust agreement.

d. **Trust Company Concerns.** Trust companies have varying policies. Some absolutely will not administer quiet trusts, particularly if the trust does not provide for a designated representative or surrogate to receive information on behalf of the beneficiary. Others require that information be supplied to the beneficiary upon reaching age 25.

e. **Distributions.** A distribution to or "for the benefit of" a beneficiary may "carry out" income to the beneficiary that must be reported on a K-1, so the beneficiary would become aware of the existence of the trust. Furthermore, the trustee may be under a duty to inquire about financial or other information about the beneficiary in the course of making distribution decisions. For this reason, using silent/quiet trusts generally is not appropriate during periods in which distributions may be made.

f. **Various Procedural Alternatives.** Various alternatives to provide for flexibility in the administration of the trust may be unavailable, such as nonjudicial settlement agreements, or the ability to obtain enforceable consents, releases, or ratifications.

g. **Change of Trust Situs.** Before changing the situs of a trust, the trustee should consider the law of the state to which the situs will be moved. If the situs is moved to a state that does not recognize silent trust provisions, the trustee may not be allowed to continue withholding information from trust beneficiaries.

h. **Trustee Resignation.** A resigning trustee will likely want a release from trust beneficiaries. That would be impractical if the trust instrument does not appoint a designated representative with the authority to provide such a release on behalf of the trust beneficiary of a silent trust.

i. **Banking Disclosure Requirements.** Under "Know Your Client" rules, banks and financial institutions may need to know about trust beneficiaries in order to open an account for the trust. The trustee cannot just refuse to reveal information about beneficiaries merely because the trust instrument has silent trust provisions. Having a designated representative or surrogate does not solve that problem. The issue may be resolved with a nondisclosure agreement.

53. Perceived Advantages and Disadvantages of Silent Trusts

a. **Perceived Advantages.**

(1) **Destroy Incentive.** The settlor believes that the beneficiary's knowledge of the trust would discourage the beneficiary from being productive and would encourage wasteful activity.

(2) **"Disability."** If the beneficiary is mentally ill or has a substance abuse problem, the settlor may be particularly wary of the beneficiary learning of the trust's existence.

(3) **Promote Family Harmony.** The settlor may not want family members to know about the interests of other beneficiaries to avoid family disputes.

(4) **Distribution Pressure.** Limiting disclosure may deter beneficiaries from discouraging other beneficiaries to request distributions. Also, limiting disclosure will keep the beneficiary from haranguing the trustee for distributions.

(5) **Avoid Conflict Between Settlor and Beneficiary.** The settlor may have a concern that "my kids will find out what stupid things I am doing with the closely-held business or other property and interfere and make my life miserable."

(6) **Protection.** Limited disclosure may protect a beneficiary from physical harm by another beneficiary who wishes to accelerate or increase his or her interest.

b. **Potential Disadvantages.**

(1) **Children Know There's Wealth; Implicit Messages from Parent to Child.**

> [I]s it really credible that the children or other beneficiaries will not see wealth and guess there is a trust? And if the trust is too large to tell the beneficiaries about, when will they be told about it? Ever? And what will they think when they learn about the trust? What message from their parents, or other grantor, will that send? Ronald D. Aucutt, *Identifying and Respecting the Core Elements of a Modern Trust*, 48TH ANN. HECKERLING INST. ON EST. PLAN. ¶ 1305.2 (2014)

Some believe that failing to disclose the existence of a trust is a mistake, because the children eventually will discover the trust and will be confused and upset over why their parents kept the trust a secret. EILEEN GALLO AND JON GALLO, SILVER SPOON KIDS 186 (2002).

(2) **Address Incentive Concern with Trustee Discretion.**

> [K]eeping a trust secret from a beneficiary is seldom, if ever, the best choice, particularly when the issue is being addressed at the drafting stage. For example, knowledge of a trust's existence should not create a disincentive to the beneficiary's leading a productive life if the trust makes clear that the trustee's discretion should not be exercised to enable a non-productive lifestyle. If the trust is written so as to reward industrious lifestyles and to penalize "loafers," then the trustee should not be forced to support an unhealthy lifestyle and, to the contrary, the beneficiary might have more incentive to be more productive than would be the case in the absence of the trust. Benjamin H. Pruett, *Tales From the Dark Side: Drafting Issues From the Fiduciary Perspective*, ¶X.E. (2014).

(3) **Family Communication and Training Is Preferable.** A silent trust says "I'm throwing up my hands. Let someone else take responsibility until he reaches age 45." A better approach is to analyze what the client really wants and design plans best structured to achieve those goals. Talk about what motivates really good children. Some family offices devote a lot of resources and effort to train children and foster family values.

(4) **Conflicting Studies Re Effect of Family Wealth on Ambition.** Anecdotal evidence and academic studies point in many directions regarding the connection between inherited wealth and personal ambition.

(5) **Deprives Beneficiary of Information to Plan.** Keeping the beneficiary from knowing about the trust deprives the beneficiary of information about the trust assets and inhibits the ability to engage in rational planning about financial matters. The child may have made higher quality (and more expensive) education choices if the beneficiary had known about the trust.

(6) **Pre-Nuptial Agreement.** The beneficiary may not pursue negotiating a pre-nuptial agreement, not realizing that he or she has any significant assets. If the beneficiary does sign a pre-nuptial agreement, the trust assets will not be disclosed (because the beneficiary did not know about them) and the agreement may be invalid. The settlors may think this would not be marital property in any event that could be divided on divorce (but that may not be true in the jurisdiction where a beneficiary is ultimately divorced). In any event, quiet trusts present significant problems for beneficiaries regarding pre-nuptial agreements.

(7) **Lack of Oversight.** If neither the beneficiary nor anyone else is receiving information about the trust, there is no one to correct breaches of trust. The trust assets may be largely dissipated before the beneficiary has the opportunity to become aware of the trust and of serious breaches of trust that have occurred in the meantime.

54. Silent Trust May Put Trustee at Greater Risk

a. **Perceived Advantages for Trustee.**

(1) **Buffer With Beneficiary.** Quiet trust provisions may be perceived as creating a buffer from having to deal with the beneficiaries. (But that seems just to delay the inevitable; the situation may be worse when the beneficiary finds out years later that he or she was a beneficiary and did not know.)

(2) **Avoid Hounding for Distributions.** The trustee will not have to put up with numerous requests for distributions that the settlor anticipates would be unreasonable distribution requests.

(3) **Avoid Conflict of Duty to Inform and Duty of Confidentiality.** If the duty to inform is not waived, giving information to one beneficiary about the trust might in some situations conflict with the trustee's duty of confidentiality to another beneficiary (for example, the reasons for distributions to the other beneficiary). Waiving the duty to inform as to some but not all beneficiaries may solve the duty of confidentiality problem but may then cause a trustee to be in breach of its duty of impartiality.

b. **Disadvantages for Trustee.**

(1) **Poison the Relationship.** Lack of disclosure may cause the beneficiary to be suspicious of the trustee once the beneficiary learns about the trust. "When trustees make an effort to communicate with beneficiaries, beneficiaries feel valued. This is important because it means that if investments later fail or concerns arise, beneficiaries will be less likely to sue." Maureen Batemen & Ellen Berkowitz, *Can We Talk?*, TR. & EST., at 44 (Mar. 2005).

(2) **Greater Danger When Possible Breach Is Discovered Long After the Fact.** If a beneficiary learns of a breach long after the event occurred, the beneficiary may react more negatively than if the beneficiary is kept apprised of decisions as they occur.

(3) **Litigation Is a Hindsight Exercise.** Litigation is backward looking with the benefit of hindsight; the trustee is always defending against a Monday morning quarterback. If a disclosure had been made prior to a particular action, the beneficiary likely would not have objected.

(4) **Secrecy Seems Sinister.** Disclosure and transparency are indications of good faith. Concealment may be viewed as evidence of bad faith.

(5) **Duty of Impartiality.** Having to limit the information given to some but not all beneficiaries may inhibit the trustee's duty to comply with the duty of impartiality. For example, the beneficiaries would not all have equal opportunity to submit requests for distributions. However, even without a quiet trust provision, a trustee may provide some types of information to some beneficiaries and not to others without violating the duty of impartiality as long as the decisions are "fair,

reasonable, and impartial in light of the context and reasons for the communication." RESTATEMENT (THIRD) OF TRUSTS §79 cmt d.

(6) **Statute of Limitations Concerns.** If the beneficiary is not apprised of trust activities, is the statute of limitations tolled on breach of duty actions until after the beneficiary has learned of the trust?

The Uniform Trust Code has a two-part statute of limitations. (i) A claim for a breach of trust must be commenced within five years after the first to occur of the trustee's removal, resignation, or death, the termination of the beneficiary's interest in the trust, and the termination of the trust itself. UNIF. TRUST CODE §1005(c). Some UTC states have reduced this time from 5 years to 1-3 years. *See* Alan Newman*, You Don't Know What You've Got Till Its Gone: Time-Barred Claims Under the Uniform Trust Code,* 48 REAL PROP. TR. & EST. L.J. 459, at 480 n.84 (2014) (listing statutes for 11 states plus the District of Columbia with such shortened time periods). (ii) The time period can be shortened to one year after "the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding." UNIF. TRUST CODE §1005(a). The report must provide enough information so the beneficiary (or the beneficiary's representative) "knows of the potential claim or should have inquired into its existence." UNIF. TRUST CODE §1005(b). While a beneficiary may waive the right to receive a report, the one-year statute of limitation does not begin to run until the report is delivered. If the trustee cannot give any information about the trust to beneficiaries, the one-year statute would not be available. Furthermore, the statute of limitations to contest the validity of a revocable trust may be shortened to 120 days by informing a beneficiary of the existence of the trust, UNIF. TRUST CODE §604(a)(2), and that ability would be lost in a silent/quiet revocable trust.

Because the trustee may be open to breach of duty claims for a very long time, some trustees may be unwilling to serve as trustee for silent trusts (or will serve only if it charges a higher fee).

(7) **Statute of Limitations May Be Unfair to Beneficiaries as Well.** The Uniform Trust Code provisions may also work to allow the limitations period to run against a beneficiary before he or she even knows of the existence of the trust. The five-year general limitation period begins to run, for example, when the trustee ceases to serve as trustee. If state law allows a settlor to waive the duty to inform indefinitely (or even just for qualified beneficiaries until the beneficiary is age 25), the five-year period may have run long before the beneficiary learns of the trust. For example, if the trustee resigns when a qualified beneficiary is 10 years old, the limitations period will expire in five years, when the beneficiary is 15 years old -- 10 years before the beneficiary may learn of the trust's existence upon reaching age 25. Furthermore, a "qualified beneficiary" under the UTC does not include remote remainder beneficiaries, so the settlor can waive giving notice of the existence of the trust or information about the administration of the trust to remote beneficiaries; nevertheless the five-year statute may have run long before they were aware of their interest as a remote remainder beneficiary. *See generally* Alan Newman*, You Don't Know What You've Got Till Its Gone: Time-Barred Claims Under the Uniform Trust Code,* 48 REAL PROP. TR. & EST. L.J. 459, at 475-482 (2014).

55. Designated Representative or Surrogate Provisions

a. **Statutes.** Various states (including Delaware, Florida, Illinois, Ohio, and Pennsylvania) and the District of Columbia allow the settlor to designate a representative to receive information the trustee would otherwise be required to furnish to a beneficiary and to bind the beneficiary. *See* Alan Newman*, You Don't Know What You've Got Till Its Gone: Time-Barred Claims Under the Uniform Trust Code,* 48 REAL PROP. TR. & EST. L.J. 459, at 479 n.81 (2014) (listing the statutes). For example, the District of Columbia (first to enact a representative statute) allows the settlor to modify the duties of a trustee to provide information by:

> (3) Designating a person or persons to act in good faith to protect the interests of beneficiaries, to receive any notice, information, or reports required under section 19-1308.13 in lieu of providing such notice, information, or reports to the beneficiaries.

The recent trend of statutes (and in drafting silent trusts) is to include surrogate provisions.

b. **Drafting Surrogate Provisions Even Without a Statute.** Even in UTC states that have not adopted a specific information surrogate provision, the settlor presumably could draft such a provision into the terms of the trust, because "settlors are free to specify their own methods for providing substituted notice and obtaining substituted consent." UNIF. TRUST CODE Art. 3 General Comment.

c. **Is the Surrogate a Fiduciary?** If the surrogate is a fiduciary, the accountability policy would seem to be satisfied, because someone with fiduciary duties is informed about the trust with some degree of duty to enforce the trust for the beneficiary's benefit.

Is the information surrogate a fiduciary? Most of the jurisdictions that have enacted surrogate provisions impose a "good faith" standard. The District of Columbia requires the surrogate "to act in good faith to protect the interests of beneficiaries," and the Kentucky statute requires that the surrogate either be a qualified beneficiary or a person having a fiduciary relationship to a qualified beneficiary. The other state surrogate statutes do not specifically mention whether the surrogate is a fiduciary. Commentators differ as to whether the surrogate is a fiduciary unless the trust instrument specifically provides that the surrogate is or is not a fiduciary (assuming such a designation is enforceable).

d. **Who Serves as Surrogate?** Finding someone willing to take on the responsibility of serving as a surrogate to receive information for the beneficiary may be difficult. In practice, the role is often filled by family members such as an older sibling, aunt, uncle, or a professional adviser close to the settlor. Statutes that specifically provide for a surrogate generally state that the trustee cannot serve as the surrogate.

e. **Provide for Appointment of Surrogate Even If One Does Not Serve Initially.** Even if someone cannot be identified to serve as the surrogate initially, the trust instrument may include provisions for the appointment of a representative or surrogate so the role can be filled at a later date if desired and if there is a viable candidate to fill the role at that time.

f. **Can the Surrogate Enforce the Trust?** The comment to §1001 of the UTC says that a person who may represent a beneficiary under the UTC article 3 provisions has standing to bring a petition on behalf of the represented beneficiary. That would be essential in order to satisfy the fundamental accountability policy requirement for trusts. Even if the surrogate can bring an action, various questions arise. May (must) the surrogate tell the beneficiary? Must the surrogate directly seek redress by suing the trustee? May the surrogate be reimbursed for expenses and from what source? These issues could be addressed in drafting the trust instrument.

g. **Does Notice to Surrogate Start Statute of Limitations?** Some statutes (Florida [by making the surrogate a representative under UTC art. 3], Maine, and Ohio) provide that notice to the surrogate starts the statute of limitations. In other states that is not clear, even though information to the surrogate is probably intended to start the statute of limitations. The one-year statute begins to run when information is given to a "representative" of the beneficiary, §1005(a), and notice to a representative is treated as if the notice were given directly to the beneficiary, §301(a). But the "representative" cannot have a conflict of interest with the beneficiary, §302-304, and if the surrogate is another beneficiary, there may be a conflict of interest. Similarly, a person is not a "representative" if there is a conflict of interest among those represented, §303, so notice to a surrogate who represents both current and remainder beneficiaries may not start the running of the statute of limitations.

h. **Beneficiary's Recourse Against Information Surrogate.** The Bogert treatise states that a beneficiary presumably can hold the representative accountable for its handling of the information. ALAN NEWMAN, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES §965 (3d ed. 2010). In states that have imposed a good faith standard, there would be no recourse against the surrogate unless the beneficiary can show a lack of good faith. If the beneficiary does have recourse against the surrogate, what is the statute of limitations on that action?

56. Adding Silent Trust Provisions to Existing Irrevocable Trust Agreements

The alternatives to add quiet trust provisions to an existing trust include the following.

a. **Judicial Modification.** For a consent petition, all beneficiaries must consent. That obviously would not work because the beneficiary would know about the modification petition (and would therefore know about the trust). Virtual representation often will not work because the beneficiary's parent knows about the trust and the beneficiary does not, possibly creating a conflict of interest. When a guardian ad litem is used, one planner has been able to negotiate the addition of quiet trust provision with provisions for disclosing information at a designated age, surrogates to receive information, etc.

b. **Decanting.** This may be the only viable option that does not require some kind of potential disclosure to beneficiaries. Trust companies may want beneficiaries to sign a release or indemnification to authorize the decanting transaction, but then the beneficiary would find out about the trust. Adopting a quiet trust provision relieves the trustee of duties he would otherwise have; is it a breach of trust to decant into a trust with quiet trust provisions?

c. **Exercise of Power of Appointment.** If the trust includes a presently exercisable power of appointment, the power could be exercised to appoint the assets into a very similar trust with silent trust provisions. This is a very workable alternative if the trust is subject to a power of appointment that can be exercised currently.

d. **Merger.** The trust might be merged to a new trust from the pre-existing trust. But under most merger statues, the merger cannot result in a material change in the interests of the beneficiaries. Accordingly, merger typically is not helpful for this purpose.

e. **Nonjudicial Settlement Agreement.** Some jurisdictions allow trust modifications in the nonjudicial settlement agreement provisions. A requirement is that the modification cannot violate a material purpose of the trust. Is having information about the trust a material purpose of the trust?

Items 57-66 are observations from a seminar by James D. Lamm, Jeff Lanza (Former FBI Special Agent), Stephanie Loomis-Price, and Ileana van der Linde (JP Morgan, Executive Director and Cybersecurity Awareness Global Program Lead), I'll Be Back! Protecting Yourself and Your Clients from Cyber-Attack

57. Recent Notable Cyber-Attacks; Significance of Cyber-Attacks

The attack on Solar Winds in early 2020 (but undiscovered until late in 2020) has possible wide-ranging effects because many government entities (including the Pentagon and Homeland Security) and businesses (including Microsoft) uses its Orion system. Malware was added by the Russia Foreign Intelligence Service (which used to be the KGB).

Cyber-attacks on Jones Day and Goodwin Procter in early 2021 accessed confidential documents that were being sent securely. The attackers bragged that they had taken 100 gigabytes from Jones Day.

In January of 2021 cyber-criminals attacked Microsoft exchange servers that were exposed to the open web and many companies were subsequently hacked. (That attack did not impact Microsoft 365 users.)

Retaliating against foreign governments or cyber criminals for these types of attacks is difficult. While the United States no doubt is able to conduct cyber-attacks against other governments, we have what they want in terms of wealth and intellectual property, but they don't have similar jewels that we want in retaliation. "We aren't going after Chinese technology because their technology is inferior to ours." Cyber-criminals are not deterred by fear of criminal proceedings because they know they are unlikely to be extradited to the United States for prosecution. For example, one Russian criminal stole $100 million from U.S. businesses; why would Russia give him up when he is pouring money into the Russian economy?

Jeff Lanza gave, as an example, a 2018 hacking incident by Karim Baratov from his home in Ontario, Canada. He was paid by Russians to hack into over 11,000 email accounts. He was paid $100 for each account, or $1,100,000 total. Another hacker alone was paid $123 million last year.

Cyber-attacks are increasing; $6 trillion in damages globally are expected in 2021. In 2020, there were more ransomware attacks and more dangerous attacks than any previous year.

"Everyone in this session has been hacked. Your information is on the dark web somewhere. The issue is how much and how drastic."

58. Common Types of Cyber-Attacks

The three most common cyber-crimes are (1) ransomware, (2) wire transfer fraud, and (3) business email compromise.

a. **Ransomware.** Ransomware is discussed in Item 59 below.

b. **Wire Transfer Fraud.** Wire transfer fraud begins with a criminal hacking the email account of lawyers, real estate agents, title companies, or lenders to get the details of real estate transactions about to close.

The criminal poses as a party to the transaction with instructions on where to wire money for the closing, typically changing a letter or reversing several letters in the domain name. A wire transfer is almost impossible to reverse once completed.

In 2019 there were over 11,600 U.S. victims of real estate wire fraud, with losses of $211 million.

Retired FBI Special Agent Jeff Lanza recommends the following tips to avoid being victimized by this crime:

> Know that wiring instructions rarely change and be very suspicious of last-minute wiring changes. During a real estate transaction, know the phone numbers of all the parties and know their voice. Get the wiring information in person or over a verified phone number. Finally, if your gut is telling you something is wrong, investigate. You are probably right.

c. **Business Email Compromise.** The criminal highjacks email of someone in a business and sends email so the email looks exactly like it is coming from the correct address of someone in the business. If the hacker gets access to an email account, he can use it as a base for committing fraud that could affect various accounts. Attacks could include logging into other accounts using the same username and password, sending malware or links to fake login pages to contacts, who think the email is coming from you, or sending wire transfer requests to a financial advisor.

59. Ransomware

a. **Description.** Ransomware is a form of malware that restricts access to data by encrypting files or locking computer screens. The criminal demands a ransom, usually in a cryptocurrency so it cannot be traced, to release the data. The attack typically begins with the victim clicking on an attachment that then downloads the malicious code. The malware encrypts files and folders on local drives, any attached drives, backup drives and potentially other computers on the same network. A recent trend bypasses the need for a victim to click on a link by seeding legitimate websites with malicious code.

b. **Prevention.**

(1) **Phishing Training.** Create a culture of cyber-security. Attacks often come from phishing to get someone to click on a link with malware. Statistics show that 30% of people fall for a phishing attack without training, but that drops to 2% with training and test attacks over a year.

Eighty to ninety percent of all cyber-attacks are email-initiated. Phishing attacks what can be the weakest link in cybersecurity – people. Phishing attacks come in various forms. General phishing attacks a broad group (or an entire firm), hoping that someone clicks on a malicious link. "Spear phishing" targets a specific team or persons. "Whaling" targets high level executives ("we're doing an article about you in a local journal, we'll send you a draft for your input").

"Hover to Discover" – hover over the sender's name of an email message to see the true sender; hover over a link without clicking to see what site is linked; if two letters appear before the first single slash in a website, those letter refer to the country where the website is located and a foreign country code could indicate possible fraud; to preview a link on a mobile device, press and hold the link.

(2) **Good Backup of Data.** The hacker's encrypting process begins with encrypting backup files before production files are encrypted. By the time the encryption is discovered, the backup files have already been encrypted. A backup of all data should exist that is not physically connected to the computer. A good approach is to have an unconnected local backup and a second backup in the Cloud (in case the building is destroyed). If using a Cloud provider, ask what the provider will do to restore prior versions of backup files in case a backup file gets encrypted. Use the 3-2-1 rule: 3 copies of files in 2 different mediums, 1 of which is offsite.

c. **Incident Response Plan.** Prepare an incident response plan before an attack occurs including things such as (1) what consultants to call who can investigate the attack and mitigate the damage, and (2) reporting obligations that under federal and state law. Only 34% of attorneys surveyed have an incident response plan. Every minute counts after an attack occurs.

d. **FBI Contact.** The victim may contact the local FBI office. The FBI will not be able to help in getting the files back, but will provide a report that can be used to file an insurance claim. Contacting the FBI will contribute to the sense of panic in the business, because agents will be in the office checking computers and investigating.

The FBI website has good webpages about responding to a ransomware attack.

e. **Paying Ransom May Not Be Advisable; Potential Penalties.** The FBI will instruct never to pay the ransom. (But the business will reply that it will go out of business if it does not pay the ransom and have the files restored.)

Reasons that paying a ransom may not be advisable are (1) paying the ransom gives no assurance that access to the date will be restored and that the criminal will remove the data from their systems, (2) cyber-criminals share with their friends that you paid making you more likely to be attacked in the future, (3) law enforcement instructs not to pay, and (4) (this is **CRITICAL**) paying the ransom may violate U.S. sanctions laws.

Paying ransom to a sanctioned person can result in fines, even if the person paying the ransom is not aware they are paying a sanctioned person. The penalties can be substantial, from hundreds of thousands of dollars up to $20 million, depending on whether the violation is egregious. The list of sanctioned persons is over a thousand pages long.

60. Cybersecurity Insurance

Risks relating to information technology infrastructure, information privacy, and information governance liability are typically excluded from traditional commercial general liability policies. Cyber-insurance is available to protect against those types of risks. Coverage may include first-party coverage against losses such as data destruction, extortion, theft, hacking, and denial of service attacks. Losses to others may be covered.

Cyber-insurance will not necessarily pay for ransom demanded in a ransomware attack. Get assurance from the insurance company regarding coverage before paying the ransom. Also, cyber-insurance may not pay for lost downtime of a business following a ransomware attack.

61. Ethics Concerns for Attorneys

a. **Vendor Due Diligence.** Breaches can come from outside vendors, including server maintenance, outsourced IT support, practice management suites for storing documents, practice management systems, email systems, etc. The proceeding may be disruptive to the family. ABA Model Rule 5.3 requires that an attorney employing an outside vendor use reasonable efforts to confirm that the vendor's "conduct is compatible with the professional obligations of the lawyer." Comment 3 provides that the extent of the obligation to use reasonable efforts depends on the circumstances and various factors including "the terms of any arrangements concerning the protection of client information."

ABA Formal Opinion 08-451 says that, depending on the sensitivity of the information, the lawyer should consider the security of the service provider's premises and computer network, and consider written confidentiality agreements with the service providers.

Practical questions to ask vendors (annually) – What are your policies for keeping information confidential? Do you have annual cyber-security reviews? Any recent breaches? Do you store data with other providers? Do you have a business continuity plan? Do you have a disaster recovery plan? What services do you provide to other law firms in the area (and ask for references from those firms)? What is the financial health of the business? Have key employees left in the last year? Has ownership changed?

Cybersecurity firms are available to provide that type of review for all of a firm's vendors.

b. **Ethical Duty to Notify Clients of a Cyber-Attack.** ABA Model Rule 1.1 requires that lawyers provide competent representation. Comment 8 says that lawyers should keep abreast of changes in the law and its practice," including the benefits and risks associated with relevant technology."

Model Rule 1.4 provides that a lawyer must keep the client reasonably informed about the status of the matter and promptly comply with reasonable requests for information. If ransomware encrypts files in a way that impacts the lawyer's ability to represent clients effectively, the attorney must notify clients. Similarly, if the attacker threatens to post confidential information publicly, clients should be notified.

ABA Formal Opinion 483 addresses "Lawyers' Obligations After an Electronic Data Breach of Cyberattack." It has a detailed discussion of duties to current clients. The Model Rules do not require notice to a former client of a data breach, but other data privacy laws or common law duties of care, or contractual arrangements with a client may require notice to a former client.

c. **Safeguarding Confidentiality.** ABA Model Rule 1.6, titled "Confidentiality of Information," requires that lawyers "make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client." Comment 8 advises that factors to be considered in determining the reasonableness of a lawyer's effort to protect confidentiality include the sensitivity of the information, the likelihood of disclosure, the cost and difficulty of employing additional safeguards, and the extent to which the safeguards adversely affect the lawyer's ability to represent clients by making a product excessively difficult to use. Therefore, the lawyer must balance security measures with the practicality of working efficiently and effectively with the client.

ABA Formal Opinion 477R is a very helpful resource about securing communications with clients. Using unencrypted email to communicate with clients "generally remains an acceptable method," but the lawyer must determine on a case-by-case basis when encryption is appropriate. The opinion has a good summary of what a lawyer's ethical duty of using reasonable security measures requires:

> A lawyer has a variety of options to safeguard communications including, for example, using secure internet access methods to communicate, access and store client information (such as through secure Wi-Fi, the use of a **Virtual Private Network**, or another secure internet portal), using **unique complex passwords, changed periodically**, implementing **firewalls** and **anti-Malware/Anti-Spyware/Antivirus software** on all devices upon which client confidential information is transmitted or stored, and applying all necessary **security patches** and updates to operational and communications software. Each of these measures is routinely accessible and reasonably affordable or free. Lawyers may consider refusing access to firm systems to devices failing to comply with these basic methods. It also may be reasonable to use commonly available methods to **remotely disable** lost or stolen devices, and to destroy the data contained on those devices, especially if encryption is not also being used.
>
> Other available tools include **encryption** of data that is physically stored on a device and **multi-factor authentication** to access firm systems.
>
> In the electronic world, "delete" usually does not mean information is permanently deleted, and "deleted" data may be subject to recovery. Therefore, a lawyer should consider whether certain data should *ever* be stored in an unencrypted environment, or electronically transmitted at all. (Emphasis added).

62. Encrypting Documents

a. **PDF Documents.** AES encryption can easily be added to PDF documents with a password. Clients merely need to know the password to open the document. Communicate the password in the initial client meeting (the client can choose the desired password, but caution the client not to use a password the client commonly uses for other purposes). (Alternatively, the password could be communicated by telephone over landlines.) Use version 1.6 or later of the PDF standard and use strong AES encryption. (Version 1.5 and earlier versions used weak encryption.)

b. **Microsoft Office Documents.** Word, Excel, and PowerPoint documents can be protected by a strong password and AES encryption when saved using a .docx, .xlsx., or .pptx file format. (The older .doc, .xls, and .ppt formats use weak encryption.)

c. **Zip Files.** A Zip archive can be protected by a strong password and AES encryption (do not use the older and weak ZipCrypto encryption option).

63. Tax Relief From Cyber-Attack Losses

Cyber-attack losses may be deductible as a casualty loss. See IRS Publication 547 regarding individual losses. An individual must itemize deductions to obtain the benefit of a casualty loss deduction. Business loss deductions may also be allowable.

64. Multi-Factor Authentication

Use multi-factor authentication whenever offered. (For example, Amazon allows two-factor authentication.) It allows authenticating yourself in more than one way, such as (1) something you know (username and password), (2) something you have (one-time password received by email or text message), or (3) something you are (a face scan, fingerprint, or iris scan).

One panelist prefers touch id over face recognition. (Her nephews can open each other's phone by face recognition even though they don't look alike.)

At a minimum, use multi-factor authentication for financial accounts and email accounts (most email providers won't ask for the code every time you log in if they recognize your computer and IP address).

65. Freezing Credit Reports

Freezing credit reports is the best way to help prevent someone from opening fraudulent new accounts or securing credit cards in your name. Do it with all four credit reporting agencies. Freezing and unfreezing the credit report is free and will not affect your credit score. When you are opening a new account, the credit freeze may be lifted temporarily or permanently (an app is available to lift the freeze quickly when needed).

In addition, consider freezing credit reports of a minor or dependent, spouse, deceased relative, or parent to prevent fraudulent accounts from being opened in their names.

66. Practical CyberSecurity Tips

a. **Email.**

(1) Create separate email accounts for work, personal use (even for separate personal accounts), user IDs, alerts, notifications, or other interests. Compartmentalize your life and use different emails for different purposes. For example, use separate email accounts for professional communication, personal communication, online shopping, travel, charities (they have horrible cybersecurity), and children's school (they are frequently hacked).

(2) Do not use your business email for personal use or outside vendors (such as Marriott). Marriott has been hacked; do not give Marriott your main business email account with your name in it. The criminal might get the email address of someone with a particular company, discover the structure of how emails or organized for that company, and target all employees at that company.

(3) Use email accounts that do not have your name in it. For example **LLoveFastCars@gmail.com.** One panelist has seven different emails and only two have her name in the address.

(4) Do not click on links or attachments in emails (or text messages) from an unknown or suspicious sender or in emails that don't make sense.

(5) A friend's email account can become compromised and attackers can "spoof" someone's email address.

(6) Do not react emotionally to an email – "your account will be closed if you don't click here," etc.

(7) Do not unsubscribe from spam (or organizations you are not familiar with) because that notifies the sender that you have an active email address, which could result in more spam.

(8) Hackers focus on the Sent files once they hack an email account and focus on searching for these words: bank, finance, password, medical, SSN, and social security. Those are the accounts for which they will be paid the most.

b. **Passwords.**

(1) Use passwords with at least 10 characters (preferably 12-15 characters) and with a mix of numbers, upper- and lowercase letters, and special characters.

(2) One way to create an easy to remember long password is to double a "bad" password with a special character in the middle. Example: Roxy2018=Roxy2018.

(3) Another way to create and remember a long password is to use a "passphrase" such as "leavetheguntakethecannoli."

(4) Use a unique password or passphrase for each online account.

(5) Change passwords at least four times a year. (Business passwords are changed frequently, but many people do not change their personal passwords.)

(6) Consider using a password manager to keep track of all unique passwords. Good options are **Keeper**, **Dashlane**, **1Password**, **LastPass**, and **Bitwarden**. (One panelist suggested that **Dashlane** and **LastPass** are particularly usable.) The user has a long complex password to access the manager (and the manager automatically adds complex password, puts the two together, and encrypts them, resulting in a very complex password that is like a housekey split in two). Nobody has been able to hack these managers.

(7) Do not click "Remember my password" or "Remember me" on websites that you visit.

(8) If a website asks Security Questions, to help access lost passwords, make up non-personal answers. For example, for mother's maiden name, you could respond "Eggplant."

c. **Anti-Virus Software.**

(1) Install anti-virus and ad-blocking software and keep it up to date.

(2) Popular options are **McAfee**, **Norton**, and **Windows Defender**, which comes free with Windows 10.

(3) A popular free program that searches for and removes malware is **Malwarebytes**. It compliments but does not replace an antivirus program.

(4) Configure computer settings so that the operating system software and antivirus software is updated automatically. Keep software, browser, and operating systems up to date.

d. **Mobile Device Security.**

(1) Always use a strong password or biometric tool to protect mobile devices.

(2) Turn off Wi-Fi and Bluetooth when it is not needed.

(3) Download apps only from trusted sources, and regularly update apps (for their security patches).

(4) Do not give apps more permissions than they need for their purpose.

(5) Delete unused apps because they may have permission to access your personal information. For an iPhone: Settings-General-iPhone Storage-delete. For an Android: Settings-Apps-Uninstall.

(6) Enable remote automatic wipe in settings so that personal information can be erased automatically when the device is reported as lost.

(7) Consider disabling Location Services. (Apple derives a lot of information from that about your life.) For example, iPhone: Settings-Privacy-Location Services- *Scroll down to* System Services-*Scroll down to* Significant Locations. A long history of where the iPhone has been located will be displayed.

(8) Siri is always listening. Dictation history can be turned off. iPhone: Settings-SIRI and Search-Siri & Dictation History.

(9) If you connect your phone to a rental car, make sure not to synch your phone to the rental car.

e. **Public Wi-Fi Hotspots.**

(1) Using public Wi-Fi is like swimming in a public pool.

(2) Be careful with using public Wi-Fi in places like travel locations, airport lounges, or restaurants. For example, a hacker could create a personal Wi-Fi in a Delta lounge named Delta First Class, and the hacker could access everything done on that Wi-Fi account. Or in a Starbucks, a hacker might create a Wi-Fi named "StarbuckWiFi" rather than "StarbucksWiFi."

(3) Absolutely do not conduct any financial transactions or enter personal credentials on a website over public Wi-Fi.

(4) If you must use public Wi-Fi, use VPN (virtual private network).

(5) Turn off file sharing.

f. **Home Networks.**

(1) Change the Wi-Fi default name to make it hard for hackers to know what type of router you have.

(2) Change the default username and password to make it harder for hackers to guess these names. Do not put your own name on the network.

(3) Buy a new router if your router is over two years old.

(4) Use a router that has WPA2 (or WPA3) security. It uses AES encryption and long passwords to have a secured network.

(5) The router should have two networks, a primary network and a guest network. Use the primary network for all financial transactions. Put children on the guest network (for example, for distance learning, gaming, Xbox, visiting friends, etc.) Also use the guest network for any Smart Devices in the house.

(6) If a hacker gains access to the network, he can attack other devices connected to the network. If a hacker should hack the guest network (for example, through an Xbox), he would not have access to the primary network.

(7) Put Alexa, Echo, Google Home Assistant, and the Wi-Fi printer on the guest network. They are all easy to hack.

g. **They're Listening and Watching.**

(1) "Alexa is always listening."

(2) Smart Devices can be listening and watching at all times. If you are logging into anything business related, unplug or disable Alexa, Peloton, etc. "You don't want Alexa to start talking to you during a deposition." Dictation or voice logs may be created.

(3) Use a webcam cover.